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MISCELLANEOUS TAX BILLS—1989

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

MAY 10, 1989

Printed for the use of the Committee on Finance

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MISCELLANEOUS TAX BILLS—1989

WEDNESDAY, MAY 17, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m. in room SD–215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Rockefeller, Daschle, Chafee, and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-25, May 10, 1989]

FINANCE COMMITTEE ANNOUNCES HEARING ON MISCELLANEOUS TAX BILLS

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman of the Senate Finance Committee, announced today that the Committee will hold a hearing on a series of miscellaneous tax provisions.

The hearing is scheduled for Wednesday, May 17, 1989 at 10 a.m. in Room SD–215 of the Dirksen Senate Office Building.

"The Committee has received a number of requests for hearings on miscellaneous tax bills. These hearings will give the Committee an opportunity to examine these bills more closely and to hear from parties who are likely to be affected by the legislation," Bentsen said.

The bills include:

S. 353, to expand the category of individuals eligible to claim the income tax exclusion for U.S. savings bonds used for higher education expenses.

S. 442, to impose a value added tax and to provide a trust fund in the Department of Treasury for deficit and debt reduction.

S. 659, S. 838 and S. 849, to repeal section 2036(c) of the Internal Revenue Code of 1986, relating to estate valuation freezes.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order.

One of the most important jobs of this committee is to take a close look at some of the legislation proposed in the tax area. Today we will consider legislation proposed by Senators both on and off the committee: Senator Hollings' bill to bring about a value-added tax and use the revenues from the tax for deficit reduction, three bills introduced by Senators Daschle, Heflin, and Symms to repeal the provisions of the 1987 tax legislation restricting estate freezes, and a bill of Senator Exon's to expand the provisions we enacted last year that enable individuals to use savings bonds to pay for education expenses on a tax-free basis.

There are a number of economists who advocate a value-added tax on the grounds that it will promote savings, would be an effective means of reducing the budget deficit, and would help our trade balance.

On the other side you hear some criticisms of it at both ends of the political spectrum. Some people will argue that a value-added tax, any consumption tax, is regressive because lower income individuals spend more of their income on consumption than do higher income individuals. And same on the other end of the spectrum argue that it becomes a money machine for the Federal Government for any kind of program that Congress might be able to dream up, that it relaxes the discipline on government spending and so gives rise to a new era in government growth.

I am not here to advocate a value-added tax or to oppose it, but to hear what the witnesses today have to say about it, to hear both points of view. We have worked to get a balanced set of witnesses to evaluate this proposal, which Senator Hollings has advocated so eloquently and forcefully.

The second set of bills we will look at would repeal the estate freeze provisions enacted as part of the 1987 tax legislation. I have some serious questions about the scope and the complexity of some of those provisions. I think the objectives were worthy. But in trying to accomplish those objectives, the provisions have unduly complicated the tax law.

We ought to do more to encourage family businesses rather than to impede their transfer to following generations, and at the same time, I know there have been some abuses in that area, and we cannot ignore those abuses. I am hopeful that we will get some useful input in these meetings to try to tailor the provisions to address those concerns.

And finally, we will hear about the expansion of an Education Savings Bond provision that we passed last year. I pushed that provision very strongly because of my concern that the cost of education is escalating beyond the reach of most families. I have seen predictions that by the year 2007, when a child born today will be of college age, the cost of sending that child to a private university would be $200,000, and the cost of 4 years at a public university, some $60,000. So it has to be of concern to all of us.

The Education Savings Bond that we enacted last year is an important start toward addressing that problem, and we are certainly open on this committee to means of trying to improve it.

[The text of the Joint Committee on Taxation committee print dealing with miscellaneous tax bills appears in the appendix.]

Now, our first witness this morning will be the distinguished senator from the State of South Carolina, Senator Fritz Hollings.

STATEMENT OF HON. ERNEST F. HOLLINGS, A U.S. SENATOR FROM SOUTH CAROLINA

Senator HOLLINGS. Mr. Chairman, I am grateful to you, grateful to the Finance Committee for giving us a hearing on this all-important matter of enacting a value-added tax. My presentation will not focus on the technicalities of a VAT, though I would ask unanimous consent to include a VAT description in the record.

The CHAIRMAN. Without objection.

Senator HOLLINGS. You have much more expert witnesses on tax and tax matters, especially as regards the mechanics of implementing a value-added tax.

Let me point out, however, that a VAT is not a money machine. I would characterize it as a payment machine, a payment machine put in safe keeping in a trust fund at Treasury to be expended only on reducing the deficit and the debt, with no tolerance for monkeyshines such as our ransacking of the Social Security fund by putting a little paper IOU in the desk drawer and then coming back here in the year 2015 and saying, "Oops, we do not have the money, so we are going to have to re-tax again to get the money we owe Social Security, or change the trust fund into a welfare fund."

The VAT is not inflationary. Indeed, the most cruel of all taxes is the tax of interest payments on the growing national debt. It is interest costs on the national debt that are really presenting the greatest inflationary pressure. Every witness coming before your Finance Committee, and before our Budget Committee, will confirm that fact, starting with Alan Greenspan and going right on down the list.

So actually, what I am trying to do with this VAT initiative is to eliminate, demolish, that inflationary pressure. Now where do we stand? As the Cheshire Cat in "Alice in Wonderland" told Alice, "Before we decide where we are going, first we must decide where we are."

And where we are, for 8 years running now, is spending upwards of $200 billion more each year than we have been taking in. In 1990, we will spend some $300 billion more than we will take in. I can break down that number if there are any questions by members as to how exactly we arrive at that figure. They are all verified.

The national debt, as a consequence, has jumped from 1981, when it was $914 billion, to right this minute, $2.8 trillion, and as a consequence, the gross interest costs are at $275 billion this year with a net interest cost of $174 billion this year. Graham-Rudman-Hollings is not working.

The Summit conference report that you and I will vote on this afternoon is a fraud. I made an open bet to all my colleagues that the final deficit will be nearer $150 billion than $100 billion. You see, Graham-Rudman-Hollings required it be reduced to $100 billion. I say it will be nearer $150 billion. You name the amount and name the odds and I will take the bet.

Rather than growing out of the deficits, as Reaganomics contended and predicted, we are growing into deficits. While President Reagan cut some $30 billion from domestic spending, interest costs jumped from $52 billion to $174 billion. In 1981 it was $52 billion. It is now $174 billion, so in other words, we have started a huge new spending program.

Yes, we are cutting domestic spending. But through this profligacy and extravagance, irresponsibility really, in not paying the bills, we have launched a new spending program of $122 billion that buys absolutely nothing. That is $122 billion you and I could spend for education, for research, for cancer, for fighting drugs, and all the rest.

So the deficits balloon this new spending program, interest costs. It balloons at the rate of $20 to $25 billion a year. Right now, interest is going to be $25 billion higher the next year, 1990. We have been trying to hold it down, but it is a hemorrhage and we need to put a tourniquet on it. The best of government cutters, Ronald Wilson Reagan, came to town promising, "Eliminate the Department of Education, eliminate the Department of Energy," 82 different agencies to be eliminated. But he could not stop the hemorrhage by cutting programs. So we have had a shakedown cruise testing the idea that we can eliminate deficits on the spending side, as we continually hear from the Chamber of Commerce.

If you want to cut spending, let us look at it. Defense accounts for 26 percent of the budget, and entitlements, 48 percent. Now, in the area of defense you have contracts that Cap Weinberger force fed into the pipeline that are going to cost you much more to cancel than to complete, and of course, you have operation and maintenance, feeding the troops, fuel costs. They continue to go up, so you are lucky, you and I as Senators, to keep defense levelly funded, if we can just hold the line. We did not cut in this Summit Agreement at all. We cut the requested increase, but we did not cut defense.

Otherwise, with respect to entitlements, we all pledge to honor the COLA for Social Security, and pledged or not, we must pay the costs of health care going up 11.5, 12 percent. So we increased under the Summit Agreement entitlements $33 billion.

So there is no saving in defense. There is no saving in entitlements, and then 15 percent interest costs you cannot save. So you look at the remaining eleven percent of the budget, the domestic programs. You can totally eliminate the Department of Commerce and Interior, the Treasury Department, the President, the Congress, the courts, the FBI, just go ahead and eliminate the remaining domestic programs and you still have a deficit.

So much for where we are. For those worried about making the government bigger, the money machine argument, government already is bigger. The point is we are just not paying for it. We are not preventing anything. We made government bigger. We just have not paid for it. So we need taxes. That is where we are. There is no free lunch. In trying to get by, we are depleting our trust funds and putting America up for sale at fire-sale price.

The tremendous deficits have caused us to devalue the dollar, and of course, every Governor in the land, the Governor of Texas, the Governor of South Carolina, they all have an office in Brussels and an office in Tokyo, and you and I are down on the floor worried about the foreigners buying up America. The Governors are hollering, "Soo, pig, come. Buy it as quick as you can. It is half price." So if not owned by the foreigners, we will soon be controlled by foreign financing, and what we really need is to finance our own debt. That is a big difference between Japan and us, when they give you this percentage argument. They are financing their own debt. We are not financing ours.

So, look at our taxes. To begin with, we need a substantial tax, more on the order of a consumption tax, rather than excise taxes, "sin" taxes, user fees. That is fiddling while Rome burns. $5 billion to $6 billion will not do the trick. Put 10 cents on gasoline, that will not do the trick. The hemorrhage is flowing at $25 billion more a year. Moreover, both the House and the Senate have just overwhelmingly voted against a gasoline tax, unanimous in the Senate and overwhelming on the House side.

The reform of the tax laws under your distinguished leadership in 1986 are still being implemented, and I assume that the Finance Committee and Ways and Means have intention to tinker with these figures before they have really even taken effect. The only tax that other industrialized nations have used successfully that we have avoided is a consumption tax, the value-added tax.

Now we have avoided it for one main reason: it brought in far more revenue than was needed heretofore. Yet today the need is bigger than the tax. A VAT as proposed under my bill of five percent, exempting food, housing, and health care, bringing in $70 billion a year, slightly increasing over the years, would still take until the year 2023 to eliminate the deficit and the debt.

We need to impose such a tax and copper fasten it in a trust fund at the Department of Treasury to be used only to reduce the deficit and the debt, not to be used for any other purposes. We are not trying to start the gravy train again.

As I have stated, I am not a tax expert. I will be glad to answer technical questions. But you have much more expert witnesses than I on your panel. But we have raised taxes to balance the budget before, Mr. Chairman. We did it during the Korean War. We raised taxes and held interest rates down, rather than raising interest rates and holding taxes down. With lower interest rates, the United States built over 4,000 plants while waging the Korean War and under the highest of inflationary conditions. It must be remembered that higher interest rates are in essence taxes paid to the banks instead of to the government, or in this case, to Japan. We are sending Japan over $5 billion a month. They are financing our debt.

And in the Vietnam War, President Lyndon Baines Johnson paid for his guns and butter—I want to establish that historical record—President Lyndon Baines Johnson—I was there in 1968. George Mahon was Chairman of Ways and Means at that time. We worked together on it, and we raised a surtax on income, a 10 percent surtax, and as a result we delivered to Richard Milhouse Nixon a surplus of $3.2 billion.

I testified before you on the value-added tax 2 years ago after we had gotten 8 of the necessary 12 votes in the Budget Committee in favor of it. It was a bipartisan effort. Obviously it is very difficult with the President himself saying, "Read my lips. No chance." You cannot expect, for example, our House colleagues, all running for re-election, to throw themselves on the tax sword when it is not going anywhere.

But I think the message came through in the debate on the floor yesterday. Each day the light is coming through the tunnel mind of Congress as to where we are and the competition that we are in, and what we really need to do, because today we have fiscal anarchy. On the S and L problem, we put it off budget, say it does not exist. Just the day before yesterday our House colleagues in trying to get the urgent Supplemental passed, they said, "CBO, take that Drexel-Burnham $600 million fine and allocate it to our requirement under Graham-Rudman-Hollings." We just refuse to face reality. We have stopped competing. We continue to tell each other that we are fat, rich, and happy, and that there is no need for the government.

We have started down the road that England traveled at the end of World War II. You know, as she withdrew from the colonies, they told the British, "Don't worry. Instead of a nation of brawn, you will be a nation of brains. Instead of producing products, you will provide services, have a service economy. Instead of creating wealth, you will handle it and be a financial center." England has gone to hell in an economic hand basket, and we are on that same road today.

It was David Ricardo who told the economic world a couple of hundred years ago that each nation should produce according to its comparative advantage. The British suggested that to our forefathers in the earliest days of our Republic, and they allowed to Alexander Hamilton that there would be no tariffs, there would be no barriers, just the fledgling nation, the United States of America would ship what it could do best to England, and England would ship back what they produced best. And Alexander Hamilton wrote a book, "Report on Manufactures," and to sum it up, he told them to bug off. "We are not going to remain your colony."

And the very first bill that passed this government almost 200 years ago—it was in July 1789—sponsored by Jefferson, Madison, and Hamilton, was a tariff bill, protectionism, a 50 percent tariff on 60 articles, beginning with steel. My point is, we used our government to create this economic and industrial giant, the United States of America.

Now the Japanese, emulating us, have used their government to develop the state-of-the-art protectionist production and trade. You debated it yesterday. I was really impressed by the distinguished Chairman's statement.

The comparative advantage in today's trade war is government. Now the war is about won by the Japanese for they are richer than you and me. Our per capita income, $19,758 [United States Department of Labor]. The economic section of the United Nations and the government of Japan both verify that Japan's per capita income is $23,356. So I do not appear here bash the Japanese—you cannot fuss with success. I am here to bash you and me, us here in Washington.

We live in a dangerous paradox. Overdeveloped Japan is taking the underdeveloped United States to the cleaners. We have the Donald Trumps and the Eisners of Disney. They make $40 million a year, but we have our citizenry sleeping on the grates outside the Justice Department. Some justice! We have children brought into this world with undeveloped minds, minds that will never develop due to a lack of protein. We have cities rampant with crime and drugs. We have bridges and infrastructure collapsing, and while they collapse we are building water lines, sewer lines, libraries in Europe.

You and I are the largest employer in Western Europe today, but in this country we do not have any money for the environment, for health care, for teachers. Fat, rich, and happy? No, we are hungry and miserable. But before we can get happy and before we can provide for these needs that you have commented on and I have, we have to take our medicine. We have got to excise this cancer of interest costs and this can only be done with a trust fund at the Department of Treasury that is truly a trust fund, never to be used as an offset for any other than the deficit and the debt.

Let me finally just emphasize one point about the alleged regressivity of a VAT. I am talking in the political sense, because I know we have tried to ameliorate the impact on lower income brackets by exempting food, housing, and health care.

I heard this argument about regressivity when we enacted the sales tax 40 years ago in my State. I authored that bill and chaired the tax committee, as you are chairing this one. South Carolina was the poorest of the poor. We had the highest rate of illiteracy, the greatest need, the most people to educate. And we were told that a sales tax was regressive and we could not afford it. Yet we enacted a sales tax, and we allocated it to education and developed a public school system, instituted technical training to provide the skills, and today we have veritably a Fortune 500 group of industries and opportunities in my State. Regressive? When I think back over the 40 years, that is the most progressive thing I have ever done in politics. I hope we can do it up here in Washington.

Thank you very much, sir.

[The prepared statement of Senator Hollings appears in the appendix.]

The CHAIRMAN. Thank you very much, Senator, Mr. Chairman, for a very articulate presentation.

On the question of regressivity: do you feel by excluding food and housing and medicine that you meet that argument adequately?

Senator HOLLINGS. Oh, yes, sir. I go right back to my example. We recently increased our State sales tax. The Black Caucus in the State of South Carolina supported the increase from three to five percent in South Carolina, whereas we had the Chamber of Commerce opposing it. How is that regressivity?

The lower income groups, those impacted upon, realize that the greatest and cruelest of all taxes is interest costs and inflation, and that is what we are trying to do away with. And, yes, when I exempt food, the poor spend by far a greater proportion of their income on medicine, on housing and on food. So it has been studied thoroughly, particularly our sales tax—45 States have it. If you want to try to ameliorate the regressive impact, this is the way to do it.

The CHAIRMAN. Do you recall that Nakasone tried to put in a value-added tax and then finally did it in Japan, and it has not been all that well received? They say part of the political problems of Takeshita is facing today comes from the value-added tax.

Do you think the United States is ready to take that one on?

Senator HOLLINGS. Winston Churchill said nothing is more dangerous than to live in the temperamental atmosphere of a Gallup poll, constantly feeling one's pulse, taking one's temperature. The safe course, our only duty really, is to do the right thing. That is what we are trying to do, you and I, up here. If you take a poll in South Carolina today on that sales tax—I am not bragging about it; I am commenting on it—I think the poll would show we are all against it. We would not enact it. Yet, in the 40-year period there has not been a single bill in the legislature to do away with it.

All these great initiatives in government, they do not come about by polls, for Lord's sake, and no, in Japan they had demonstrations last year, and blocked the VAT. It has only been implemented in April of this year in Japan. And yes, that has given them trouble. We saw what happened to poor Al Ulman. They defeated him in Oregon trying to explain it, a value-added tax. So I am fully aware of that.

But I am tired of doing a sorry job up here. This is a fraud, this government, a total fraud at the national level. You and I down in Texas, we would have to pay the bill. We would have to provide for education. We would have to do the job, and what we are engaged in is one grand charade of "I am against taxes" and "We do not need the government," and just run up the bills and put every problem off budget. And when it collapses we will not be in a position to do anything, and we are boxing the next generation into a corner where they will not be able to move. You and I both can retire. It is time we do a good job up here before we do retire, or they might retire us when they catch on. [Laughter.]

The CHAIRMAN. Your answer to the argument that this is going to be a money machine for new programs——

Senator HOLLINGS. Oh, yes, sir.

The CHAIRMAN [continuing]. By setting up your trust fund, we are going to have a witness this morning, Dr. Walker, who will talk about using part of value-added tax revenue to reduce capital gains taxes and to do other things to encourage investment.

Do you think that it is realistic to think that we in the Congress could withstand those kinds of incursions into a trust fund?

Senator HOLLINGS. No, Mr. Chairman, I do not think that we can. I have the highest respect for Secretary Walker and I have consulted him. I have consulted Dr. Cnossen and others, and the American Bar Association, the author of the model value-added tax. But politically, if you start squandering the revenues, siphoning them into capital gains cuts or putting them into health care, and so on, then I do not think we are going to get that concurrent majority that Calhoun spoke of years ago. You need a majority. I am trying to be realistic. I am trying to get this passed. We can guarantee to every taxpayer that this is going to lower his taxes in the long run by raising his taxes in the short run. I say that because we can stop this hemorrhage of $25 billion each year just in interest cost increases. Now ultimately, if we start bringing that deficit and debt down and we lower the interest cost increase, then we could eventually have some room for education investment tax credits and so on. But let us give this, as you are doing your tax reform, a trial run for a good 5 to 10 years and really have an impact. I think the public will support it. I do not believe the public is going to support a VAT as a tradeoff for capital gains or whatever. I do not think we can get it passed.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Senator, as I understand it, you would have this money go into deficit reduction; is that correct?

Senator HOLLINGS. Solely into that, solely, Senator. Yes, sir.

Senator **Chafee**. I read the article that you wrote in the "Op Ed" piece some time ago—well, it was not so long ago, last month I guess it was—in the Washington Post, and you touch on some of those same points here about lack of education, people sleeping on grates, inadequate housing, poor health care, no money for health care—37 percent of the population is without health care—no money for teachers.

Following on with what the Chairman's question, you raise this money and at the same time you point out all these problems. How are we going to keep those who are concerned, as you are and we are, about these problems from reaching out and taking that money and spending it?

Senator **Hollings**. We are going to have to put it in that deficit and debt reduction fund. This year we have a bill in before your Finance Committee and it has bipartisan support and it is gaining support every day to make Social Security truly a trust fund, put it off budget and not used in the computation of your deficit. I want to do that same thing with this value-added tax. I cannot take care of all things. Like I said, I have got to take my medicine first. I have all of these needs backed up, but our greatest need and the one that we can and should take care of first with a value-added tax is this deficit and debt.

Senator **Chafee**. And you think that your mechanism would be a trust fund so that you would keep the eager hands of Congressmen and senators off this nice inflow of lovely dollars?

Senator **Hollings**. Exactly. I would not expect to get the distinguished senators' support on this unless the Finance Committee and the Congress could guarantee that you could not monkey with it and you could not siphon it off into other endeavors, as worthy as they might be, whether education or investment tax credits or capital gains cuts or whatever.

Senator **Chafee**. Well, I think the point you have made, and I will say this, that you are no newcomer in this. You have talked this way for many, many years, and indeed, you voted that way, so you have given us food for thought here.

Thank you.

Senator **Hollings**. I appreciate it very much.

The **Chairman**. Thank you very much, Senator Hollings.

Senator **Hollings**. Thank you, Mr. Chairman.

The **Chairman**. Delighted to have you.

Our next witness will be Hon. James Exon, U.S. Senator from the State of Nebraska.

Senator, we are very pleased to have you this morning. We are looking forward to your testimony.

STATEMENT OF HON. J. JAMES EXON, A U.S. SENATOR FROM NEBRASKA

Senator **Exon**. Mr. Chairman, thank you very much.

I am here to talk about education and what we can to enhance it. I know that you as Chairman of this committee and the committee as whole have been very much concerned about this. I think I have a bill here that is essentially not going to cause a great deal of controversy, and I hope that you will look favorably on it.

I am extremely pleased to be here this morning, Mr. Chairman, in front of you and the members of your committee, and I want to thank you for agreeing to hold hearings on S. 353, my bill to expand the educational savings bond legislation to help education that was approved by you and the Congress last year.

This legislation is straightforward. It will merely open up to relatives and to friends of future students the tax exemption on interest earned on U.S. Savings Bonds used for higher education costs that were previously granted only to parents and spouses of the eligible students. I have heard concerns expressed by a few that expanding this provision may allow for non-profit and other organizations to take advantage of this exemption. Mr. Chairman, let me state unequivocally that this is not the intent of this legislation and prohibition against such is included. I simply want to encourage grandparents and aunts and uncles and family friends to help provide educational assistance to students.

I was a cosponsor of Mr. Kennedy's original Education Savings Bill last year, and even before it passed, I was looking to expand it. Since its passage, I have received inquiries from individuals expressing strong interest in the program. However, many were disappointed to find out that as a friend or relative they were ineligible for the exemption. If we are trying to stimulate savings and encourage education, why limit such activities to such a small audience. When it comes to financing the soaring costs of postsecondary education, every little bit helps.

Most families spend a lifetime trying to save enough money to educate their children in a college. College education is a part of the American dream. Without it, the dream cannot materialize. With the rising cost of education it is becoming more and more difficult for families to afford this expense. Ten years ago, Mr. Chairman, grants comprised 80 percent of the average student aid package, with loans making up less than 20 percent. But today a student aid package is comprised of more than 50 percent in loans, leaving grants to make up less than 48 percent of the average aid package.

In recent years we have tightened up the eligibility requirements for many of the Federal financing programs, making it even harder now for some students to finance their education. For those who do not meet the loan eligibility requirements, the thought of facing the beginning of their working life already tens of thousands of dollars in debt is often enough to discourage them from taking advantage of those programs and therefore, not furthering their education. As the United Negro College Fund so aptly states, Mr. Chairman, "A mind is, indeed, a terrible thing to waste."

At one point in our history, only the children of the wealthy could afford to attend a college or university. We have come so far since then that it would indeed be criminal to start backsliding now. I have long held the belief that education is not an expenditure, but an investment, an investment in our future. We must allow more individuals to make the same investment.

By opening up this interest exemption, we are not only investing in our education future, we are also investing in the financial viability of our country. My record here in the Senate on deficit reduction is very well known. I firmly believe we need to reduce the horrendous budget deficits facing this country. Part of the solution to doing that is to stimulate savings. If we can encourage individuals to bolster their personal savings by investing in their country while helping education through the Savings Bond, we are going to help this country out a great deal in many ways.

Mr. Chairman, in the interest of conserving time, I ask that the balance of my statement be appended in the record and I will be glad to respond to any questions that the committee may have.

[The prepared statement of Senator Exon appears in the appendix.]

The CHAIRMAN. Without objection it will be done.

Your work in support of education is well recognized, and there is no question that, with the international competition that we are facing, one of the things we are going to have to stress is a continuing improvement of the education in this country.

Can you give me an idea as to the position of the Administration on the legislation that you are proposing?

Senator EXON. I have not heard directly from the Administration on this, but the last Administration was evidently very much in favor of strong expressions, I think nearly unanimous expressions, of support for the bill that allowed mother and dad to do this. I would think that this Administration who have pledged already to be foremost in promoting education would be supportive of this program.

The CHAIRMAN. Thank you.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Obviously any program such as this diminishes Federal revenues, that is where the money comes from. First, I just want to say throughout my career in government and when I was Governor, we expanded all kinds of college assistance, as you did in your State, and so I am four square for expanding opportunities for college education. However, there are a couple of parts in this bill that bother me.

One, isn't this a device that really is going to help the wealthy certainly, the poor are not going to be helped, and the moderate incomes probably not helped very much either? In other words, who is going to do the type of investing that can be of any major assistance to a student? You are talking $10,000 bonds. You are not talking $100 Savings Bonds.

Have you given that much thought, and what is your answer to that?

Senator EXON. I have, Senator Chafee, and that may be a legitimate criticism at first blush on this proposition. I simply say that it is a step in the right direction. I frankly believe that if this will catch on, it would have the dual effect, as I indicated in my statement, of not only providing significantly additionally funds for educational costs that possibly next to medical costs seem to be going up at an ever-increasing rate. And yet, we are faced with the proposition, as you know, back in the States, when you were Governor and when I was Governor of my State, with the cost of more and more taxpayers' dollars going into education.

This is not the perfect answer. It will not cover all of the concerns that I have. I indicated only that it is a significant step in the right direction. There is no piece of legislation that probably cannot be criticized on some points. But I firmly believe that by expanding this—and I emphasize expanding this—the argument that you made may have applied more appropriately to the Kennedy bill that I was a cosponsor of that we passed last year because that was mother and dad. Now we are trying to get to other family members and even friends, maybe wealthier friends, outside of the immediate family, who would like to pitch in and help someone along the line with this modest program that would prove in the long run very beneficial to individuals and keep away from that heavy debt that most of our youngsters coming out of college today are faced with.

Senator CHAFEE. I think your point about the debt is a good one. I would be interested statistically in whether our colleges indeed, or the students indeed, are kept away from college because of costs. Now that sounds like a radical statement. I know everybody shudders about college costs, but I always maintained in my State, and nobody challenged me on it, that any youngster in the State of Rhode Island who is qualified to go to college, that is academically, could go to college through some kind of a program. It was not going to Princeton and it was not going to Stanford, but we had a series of colleges that we started, whether they were community colleges, junior colleges, or whether they were State universities, whatever it was, we had it arranged, and I suspect that it is probably true throughout the United States, that youngsters can go to college, some college. Now I see the real problem here is that in many instances they are coming out with tremendous debt, and that is not good because of all the ramifications to that. But it is curious that certainly in some the more prestigious colleges they still continue to be overwhelmed with applicants, despite the decreased pool. I mean this is in an era when there are fewer total available to apply. But in any event, you have a thoughtful idea here, and I certainly appreciate your bringing it to us.

Senator EXON. Senator Chafee, just let me, if I might, Mr. Chairman, make a brief comment.

I too would be interested in knowing the answers to some of the questions that you raised. I suspect though from my knowledge of my children and now one of my grandchildren just staring in college that they are faced with far different costs than they were when you served as Governor of your State and I served as the Governor of my State. I think the thing that we have to remember here is that while it is true that most of the young people today I suspect are going to college if they have that drive and desire. The costs of a college education today and the indebtedness that so many of them are taking I am fearful is creating a climate that in the future may see more of a down trend in particular individuals seeking their maximum benefit, and I think that you and I would both agree that if the capability of the individual student is there, then as nearly as possible, we should see that they, too, could get into MIT if they have that ability and that desire. So it is a step in the right direction in fairness it seems to me.

Senator CHAFEE. Thank you.

The CHAIRMAN. Senator, thank you very much for your testimony.

Senator **Exon**. Thank you, Mr. Chairman.

The **Chairman**. Our next witness is Mr. Dana Trier, who is the Tax Legislative Counsel for the United States Department of the Treasury.

Mr. Trier, we are pleased to have you and we would like your comments on the value-added tax, estate freezes, and the education approach of Senator Exon.

STATEMENT OF DANA TRIER, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. **Trier**. Let me start with the VAT.

We understand fully Senator Hollings' points. The Treasury Department has studied the VAT for some time, as you know, as part of various proposals. Several years ago we issued a long volume on the VAT. However, as might be predicted, given the opposition of the Administration to a tax increase or a new tax, I have to oppose on behalf of the Administration Senator Hollings' bill.

With respect to the education savings bonds and the proposal that was just discussed, which was basically to extend Section 135's benefits beyond the family to grandparents or whatever, we also have to respectfully oppose that provision.

To explain why that is, let me begin with a few preliminary remarks. I think all of us in this room view education in the United States as a significant issue, view it as very important to promote it. President Bush has called himself the education president, and I think he does feel it is very important. The basic tax issue, though, that we have with respect to Senator Exon's proposal relates to the following:

The existing statute, as you know, has a phase out between $60,000 and $90,000 for families filing joint returns such that you cannot get this benefit. We are concerned that if you extend the provisions so that grandparents, for example, can make these types of gifts—or rather buy these types of bonds—that you are going to have the unfortunate consequence of, in fact, defeating that phase out.

It would be fairly easily in a wide variety of circumstances, I think, for the grandparents to be the nominal source of the college savings bonds, be within the income limits, even though somewhat wealthy, not be subject to the phase out, but on the other hand, have the family, which is well above the phaseout limits, making $120,000 or $90,000 or $100,000, nevertheless, really be benefiting from the exclusion indirectly by simply supplanting the income of the grandparents who are buying the college savings bonds. So although we really do share the Senator's intent, we think that it simply is not something that would work in this context.

I did put in my testimony in the statement our estimated revenue losses from the provision. They range from $4 million in 1990 to $96 million in 1995, going up gradually over that period of time.

The third item, of course, is the various bills that would seek to repeal Section 2036(c), the provision which was enacted in 1987 and amended again in 1988 to deal with so-called estate freezes. As you know, Section 2036(c) basically, I think, was directed at the estate recapitalization transaction, the transaction in which a closely held business owned by an older generation is recapitalized, with the older generation getting preferred stock and the younger generation getting common with the appreciation from the common, hopefully inuring thereafter to the benefit of the younger generation and not passing through the estate tax system. This provision applies in that type transaction to bring back the common into the estate of the older generation. It could arguably apply to a wide variety of other cases as well.

With respect to these bills, let me say the following. First of all, whatever is true about the statute itself, Section 2036(c) was clearly intended to address an area in which there was fairly wide-spread tax avoidance. I think we are all aware of that. I think we would say that something had to be done. The statute, since its enactment, has been criticized for a variety of reasons, for being overly broad, for being very uncertain in its application. It uses a variety of now abstract terms, like enterprise and direct or indirect transfer, et cetera, and we understand fully the views of those who are concerned with the application of the statute. Frankly, we share some of those concerns and have been concerned with them as we are trying to develop an interpretation of the statute.

However, it is also clear that the repeal of the statute at this time would raise serious revenue concerns, and we are all in the situation where we have to be very attentive to that. The numbers in my testimony indicate that if we repeal it retroactively to its beginning, we would lose $2 million in 1989, $25 million in 1990, 1991 would be $72 million, and it would go all the way up to $550 million in 1995.

Therefore, given the fact that the statute at least was intended to be responsive to, or it was directed at, an area of significant tax avoidance, and given this revenue impact, we cannot support repeal of the statute at this time. That does not mean that we would not be willing to work with any interested party who has concrete proposals for either modifying the statute or for scaling it back or replacing it.

The CHAIRMAN. Mr. Trier, let me interrupt you.

What I am listening to is no recommendations, nothing specific——

Mr. TRIER. That is right.

The CHAIRMAN [continuing]. And we have had the problem of ambiguity. Section 2036(c) is drafted in broad terms, and it has been in effect for some time now, and we have seen businessmen and estate planners waiting for the IRS, waiting for Treasury to give some guidance. And I am not hearing that from you. We need something specific.

For months, Treasury and the IRS have publicly hinted that a notice providing clarification of this provision is imminent, but we still do not have it. We had Treasury before us talking about LBOs and saying they might do this or might do that, then appearing before the Ways and Means Committee, saying, "No, we have backed off of that." Now we are getting some guidance out of OMB on some tax provisions, and I think it is time that Treasury steps up to it and begins to tell us what they are for and to be specific in that regard. That is what we are asking of you.

Now we want to work in cooperation with you. You say you are ready to listen if we come up with some terms. Let us have some consultation and let us see if we cannot work together. There is a great deal of information that Treasury has. You have the tax records to look at. You can see what has worked and what has not worked, but take a position. Let us know.

Now insofar as the value-added tax, on that one, I understand from your description it is a duck, and therefore, it is a tax, and I know you are under limitations about proposing any kind of a tax. But again, we would like advice and counsel.

If you are faced with the alternative of a value-added tax or some change in the personal income tax in order to raise money, which way would you go, knowing you are against both of them? Those are the kinds of things I want to hear. You are supposed to have a bunch of experts over there, and we are looking for counsel and we are looking for advice.

Would you comment?

Mr. TRIER. First, with respect to the estate-freeze transactions, there are really two things, I think, going on. One is the guidance on the existing provision. Since the amendments which were made last fall, or early last fall, under TAMRA, we have, I must say, the IRS has worked very diligently to come up with guidance on that provision. There has been a significant amount of work on it: I personally I have worked on that.

I would anticipate that shortly after the Assistant Secretary for Tax Policy of the Treasury comes in that we would be able to issue significant guidance on some of these vague terms and perhaps define the scope of this admittedly ambiguous statute, which I might remind you that the Treasury Department was not responsible for. Frankly, I think we really want to get that out absolutely as soon as possible. There are some very difficult calls to be made. Rightly or wrongly, we have decided that those calls are best made by the person who is going to be the representative of the Administration on tax policy.

As to working on the specific proposals——

The CHAIRMAN. Let me comment on that, too.

Mr. TRIER. All right.

The CHAIRMAN. We have gone to great lengths in this committee to act on those names that are sent to us, and here it is past the middle of May, and we have expedited the consideration of them by this committee.

Mr. TRIER. I understand.

The CHAIRMAN. But they have been slow in coming from Treasury and the Administration. We want to help.

Senator CHAFEE. I would like to join in that, Mr. Chairman. The Assistant Secretary for Tax Policy is a crucial person around here. I do not think that any representative from the Administration is better known to this committee than whoever fills that slot. And it is really a quandary when we do not have one. We are dealing with taxes all the time here.

Do you know what is happening down there? Is a name on its way?

Mr. TRIER. I believe that is true, sir, that a name is on its way, and I believe hearings will be held soon. Senator Bentsen can——

Senator CHAFEE. Well, I do not know why we jump on you because you are not responsible for it, but——

Mr. TRIER. I was going to say that I have borne some of the burden myself as a——

Senator CHAFEE. I know. You are an innocent. You are caught in the crossfire.

Mr. TRIER. Result of that gap.

Senator CHAFEE. But if you happen to bump into the President, mention it to him. [Laughter.]

Mr. TRIER. I would be happy to.

I do believe on this particular issue—and you know, you never want to make false promises—but there is an awful lot of work that has been done already, and I think on this one, the issues can be teed up. Now that does not remove the fact that there is, in fact, a considerably amount of vagueness in the statute. We think that the guidance we will issue will be able to address a considerable amount of that vagueness, but there are problems with the statute. Now, I must say in all honesty, my efforts and the efforts of my staff over the last few months have been primarily dealing with this statute and primarily attempting to make sense of it. However, we are willing to go beyond just listening. We are willing to go beyond that to consulting with people from the congressional staffs or other people who have proposals and want to discuss various approaches to it, and we are quite aware of several approaches out there that are being discussed others.

The CHAIRMAN. Well, I must say that the name has been sent up and it is Mr. Ken Gideon. But the papers have not been received from the Administration, so we cannot act until then, but we will act very expeditiously when they complete their paperwork and send it to us.

Did you have any further questions?

Senator CHAFEE. I just want to ask one quick question.

In connection with Senator Exon's proposal, setting aside the money loss, what about the monitoring of such a program? It must be very difficult, isn't it, from the government's point of view?

Mr. TRIER. Senator Exon's particular proposal, or the college savings bond rules in general?

Senator CHAFEE. Well, as the law now exists and as the extension is proposed by him, I should think they would both be equally difficult.

Mr. TRIER. Well, I think that the statute may have some difficulties in monitoring, but I do not believe we find the basic proposal to be unduly onerous to monitor. The point that I discussed earlier, which would be the question of whether you would avoid the phase outs, be able to avoid the phase outs, under Senator Exon's proposal, if you had some sort of anti-avoidance provision to deal with that problem, I would think that would be very difficult to monitor. So to the extent that you are intending to have a proposal that only is directed to the low or moderate income people to expand it beyond the basic family unit, I think would raise monitoring issues.

Senator CHAFEE. Well, that is what he proposes.

Mr. TRIER. Yes, and that is why we opposed it. That is why we opposed the proposal.

Senator CHAFEE. Yes.

Thank you.

The **Chairman**. Senator Rockefeller.

Senator **Rockefeller**. No questions, Mr. Chairman.

The **Chairman**. You have not answered my question, obviously, on value-added taxes, and I suppose I will just defer it until we get the Assistant Secretary in.

Mr. **Trier**. I have been informed, which I thought to be true, that the papers have been sent out, so. I understand that they were only sent up in the last week, but I believe they are complete. So I hope we can get the action as soon as possible.

Thank you very much.

The **Chairman**. All right. Thank you, Mr. Trier.

[The prepared statement of Mr. Trier appears in the appendix.]

The **Chairman**. Next we will have a panel that is composed of Dr. Sijbren Cnossen, who is professor, faculty of economics, Erasmus University, Rotterdam in the Netherlands; Dr. Charls Walker, chairman of Charls Walker Associates; Dr. Joseph Pechman, senior fellow emeritus, Brookings Institution; Mr. Thomas Swanstrom, chief economist for Sears, testifying on behalf of the American Retail Federation.

Would you please come forward, gentlemen.

I would ask that you limit your prepared testimony to five minutes and we will take the entire testimony for the record, and then that will give us the opportunity to ask the kind of questions that we would like to ask.

Dr. Cnossen, we are most appreciative of your being here as one who has had, not only the academic background on these subjects, but also experience with it in his country, and we look forward to your testimony.

STATEMENT OF SIJBREN CNOSSEN, Ph.D., PROFESSOR, FACULTY OF ECONOMICS, ERASMUS UNIVERSITY, ROTTERDAM, THE NETHERLANDS

Dr. **Cnossen**. Thank you, Mr. Chairman.

I appreciate the invitation and the opportunity to participate in this hearing, and I hope that my remarks will contribute to your understanding of value-added taxes, as well as to the general dialogue on taxation approaches to reducing the Federal budget deficit.

Mr. Chairman, Holland was the first country to fire a salute in recognition of the young republic, the United States of America. Barbara Tuchman, an eminent U.S. historian, wrote a wonderful book about the event. Mr. Chairman, as a Dutchman, I am proud to be able to fire the first salute in support of S. 442, Senator Hollings' draft bill on the value-added tax.

Last November, I had the privilege of discussing with congressional staff here in Washington the concept of a value-added tax as one step in reducing the structural budget deficit. Those roundtable discussions were published as a special report in Tax Notes of January 9 last. I am submitting a copy of that for today's hearing record, along with an analysis which I have prepared for the committee concerning the most desirable rate structure for a value-added tax.

[The information appears in the appendix.]

The Federal budget deficit is the reason why the issue of a VAT in the United States arises. The Federal budget deficit itself acts like a hidden tax, converting savings which would otherwise be used for productive investment into fuel for government consumption and driving up interest rates.

The United States has a particularly meager savings rate compared to other industrialized countries, and this exacerbates the economic impact of the Federal deficit. Although it may sound surprising, compared to other industrialized countries, the United States is not a high tax country. For example, in European countries total taxes as a percentage of gross national product are 50 percent higher than in the United States, and among industrialized countries the United States is an exception in that it does not have a value-added tax.

I think major points to bear in mind in considering a value-added tax are:

One, the value-added tax is the most neutral form of tax. If properly designed, it does not channel consumer choices or create economic distortions. It does not discriminate against certain products and in favor of others. It does not discriminate in favor of capital-intensive production processes and against labor-intensive production methods, or vice versa. Such tax neutrality, in my opinion, is highly desirable in the increasingly interdependent and competitive world economic structure.

Two, the value-added tax integrates the taxation of services with the taxation of goods. It permits the taxation of consumer goods while fully relieving capital equipment, intermediate goods, and raw materials from taxation, thus avoiding cumulative effects of tax on tax. It permits comprehensive border tax adjustments, which means that imports can be taxed at the same rate as domestically produced goods, and that exports can be fully freed from tax in order to promote international competitiveness for American-made products.

Three, the value-added tax is not inherently inflationary. It is not costly to collect. The multistage collection feature of a value-added tax does not cause greater working capital requirements for American business.

Four, in the U.S. context, the value-added tax does not seem to run the risk of becoming a Federal money machine. The tangible economic dangers of a continuation of the budget deficit with its detrimental effects on saving and investment appear greater than the problems of creating a new tax instrument.

Five, a value-added tax can be operated, either independent of the retail sales taxes of the individual States, or in conjunction with them.

Six, the regressivity of a value-added tax can be eliminated by non-VAT measures, such as means-tested transfer payments and various entitlements, which offset the impact of a value-added tax on lower-income segments of the population.

In designing a value-added tax, I submit that it is essential to realize that economic neutrality and administrative feasibility are best served by a single, uniform tax rate which applies to virtually all goods and services. Because of time constraints today, I will summarize the major reasons for a single uniform rate without exemptions. These reasons are spelled out in detail in my prepared remarks. Stated succinctly, a zero rate or lower-than-standard rate on essential commodities is an ineffective instrument for narrowing income differences, and it diminishes the net tax revenues which otherwise could be collected.

In conclusion, I believe strongly that a value-added tax should be used only for the generation of revenue. Whereas other taxes, notably income tax, may be an important instrument in taxing people according to ability to pay, the sole purpose of a general consumption tax, a value-added tax, is raising revenue. In fulfilling that role, economic distortions should be minimized, and administrative and compliance costs should be kept as low as possible. For a value-added tax, a single, uniform rate would make an important contribution to achieving these objectives.

It has been an exceptional privilege, Mr. Chairman, for me to share some thoughts on the value-added tax with you in the brief time available this morning, which I see I have used up, and I thank you for that opportunity.

[The prepared statement of Dr. Cnossen appears in the appendix.]

The CHAIRMAN. Dr. Cnossen, we are going to be back to you because I am very interested in your experience in this regard.

Dr. Walker.

STATEMENT OF CHARLS E. WALKER, Ph.D, CHAIRMAN, CHARLS E. WALKER ASSOCIATES, WASHINGTON, DC

Dr. WALKER. Thank you very much, Mr. Chairman.

It is a privilege to be here and it is a privilege to testify with Dr. Cnossen. He has made the case extremely well, and so I will extend my remarks a little bit beyond his in other ways.

Senator Hollings is to be strongly commended for introducing S. 442, which would establish a value-added tax, and I agree with Senator Hollings that the top priority use of the VAT funds is to reduce our huge and chronic Federal deficit. As Professor Cnossen has pointed out, VAT's positive attributes are huge. Its shortcomings can be effectively dealt with.

Second, my differences with Senator Hollings are not truly substantive and are offered as appropriate means for improving his legislation and broadening its positive economic effects.

First, the VAT I propose would permit no exceptions or exemptions, but apply the single-rate tax to all goods and services produced for profit as defined in the Federal Tax Code. This would significantly increase the revenues generated by the tax by 70 percent, or to $125 billion a year by 1991 for a 5 percent tax, versus the $70 to $72 billion that the Hollings bill would yield.

I would deal with regressivity by providing a refundable income tax credit to low income Americans, an approach supported by most economists.

Second, I would levy the tax through the simple subtraction method rather than the more complex invoice-credit system; the single rate VAT would permit this. This would give you a faster start-up, minimum complexity, minimum administrative problems, less impact on the IRS budget, number of agents required, et cetera.

Third, and finally, I would designate a significant, but not large portion of the proceeds of the tax, maybe one point or $25 billion, to be used to cut the capital costs of investment in productive equipment, thereby adding to future competitiveness of the U.S. economy.

And here I call your attention to three charts at the end of my statement, the first of which shows that capital costs of investment in the United States today, according to Professor John Shoven of Stanford, a distinguished economist. Our capital costs are twice as high as in Japan and substantially higher than in Western Europe.

Second, if we look at the impact of the U.S. Tax Code changes since 1981, on the cost of capital for equipment used in manufacturing—and I single that out because it is so important to competitiveness for productivity purposes—we see that the user cost of capital has increased by nearly 23 percent between 1981 and 1986. This is a very significant figure with respect to our efforts to maintain our competitiveness.

Third, if we look at it in a different way, before 1981 the effective corporate tax rate on equipment in manufacturing was about 28 percent. That dropped to about what we would call a theoretical expensing level in 1981 with the enactment of the 10-5-3 depreciation system, which you and Senators Bentsen, Packwood, and Heinz cosponsored. But the effects of legislation in 1982 and 1986 raised that effective corporate tax rate on new investment and equipment to 46 percent. How could this be higher than the basic 34 percent rate? Because we are back in the situation of the 1970s of under-depreciating; inflation is resulting in under-depreciation of business assets.

The Chairman said this morning that I was proposing that some of the VAT revenue be used to cut capital gains. I think the proposed capital gains tax cuts will pay for themselves. I would like to use a significant but small part of the VAT revenue to restore some sort of investment tax credit or more accelerated depreciation. You could set up a targeted investment tax credit for about $25 billion which would lower the capital cost of equipment by somewhere in the range of 10 to 20 percent. That would be a very good, big step in reversing the trends since 1981.

Finally, Mr. Chairman, there are very big political problems involved in getting two things that I suggest in my statement. Take the single rate for the VAT. There would be great efforts to obtain special exemptions or rates for small business, farmers, and various other taxpayers. I would resist that very strongly. I think those efforts could be beaten back by whichever President of the United States who sees fit to take up the cudgel for this effort. VAT is a solution in search of a leader.

That leader has to be a President when he emerges, he should have at least two non-negotiable demands as the price of that leadership. One would be the single rate as recommended by Professor Cnossen and myself. The second would be a series of Constitutional amendments, difficult to get, but necessary to cap the VAT so it would not become a money machine.

Mr. Chairman, with those changes I would agree strongly with Senator Hollings, and I say the sooner the better we get a VAT, the better off we are all going to be.

Thank you very much.

[The prepared statement of Dr. Walker appears in the appendix.]

The CHAIRMAN. Thank you very much, Dr. Walker.

Dr. Pechman, we are please to have you.

STATEMENT OF JOSEPH A. PECHMAN, Ph.D, SENIOR FELLOW EMERITUS, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. PECHMAN. Thank you very much, Mr. Chairman.

I appreciate the opportunity to discuss the value-added tax with this committee.

I would like you to look at the one table that is attached to my testimony. My remarks will be directed primarily at that table.

The table summarizes the results of my research on the distribution of tax burdens by income classes that I have been conducting for the past two decades at the Brookings Institution. It shows the effective Federal, State, and local tax rates by deciles, or groups of 10 percent of the population from low to high, and also for the top 5 percent and top 1 percent over the period 1966 to 1988.

The calculations from 1966 to 1985 are based entirely on files that I, myself, have prepared at the Brookings Institution. The calculation for 1988 is based upon the recent congressional Budget Office estimates of what has happened since the Tax Reform Act of 1986.

The major point of the table is that the tax rates in the last two decades below the tenth decile have not changed very much. They have been about 16 or 17 percent in the lowest decile, going up to something like 25 percent in the sixth, seventh, and eighth deciles.

In the 1960s the top decile had an effective tax rate of 30 percent, and the top one percent of the population paid almost 40 percent in Federal, State, and local taxes. By contrast, in 1988 the tax burden in much of the distribution below the top 10 percent is somewhat higher than it was in 1966, due primarily to the bracket creep that occurred during the 1970 inflation.

But please look at the top 5 and top 1 percent. The effective tax rate for the top one percent has been reduced from 40 percent to about 27 percent, which is a cut in effective tax rates of about 30 percent. In these circumstances, I submit that it would be unconscionable to enact a tax which has virtually no effect on the tax burdens of that top 1 percent or 5 percent and fully affects the incomes and taxes of people in the lower- and middle-income classes. What you would be doing by a value-added tax is imposing extra tax burdens on people whose taxes have remained high, or as high as they were 20 years ago, while sparing the people in the top brackets.

Now the proposals that have been discussed by the previous two speakers, means-tested transfer payments or tax credits for lower-income classes, do not help. All that happens is that you exempt the very lowest income groups from the value-added tax, but you keep the tax on the middle-income groups as high as the statutory rate. By contrast, the top income classes still will not pay very much under a value-added tax.

So the proponents of value-added taxation, it seems to me, have to answer the equity question. Why, in light of this historical record, do we have to impose additional tax burdens on the middle-income classes and let the people who have already had large tax cuts go free? I do not understand why it is necessary to resort to a regressive tax when in the last 8 or 9 years we have actually reduced our income taxes to by about $200 billion a year. In effect what we would be doing is replacing the income tax, which everybody agrees is a better tax, with an inferior tax that imposes excessive burdens in the low- and middle-income classes.

I might also add that, before the Tax Reform Act of 1986 was passed, I would have said that it would be unfair to use the income tax to raise additional revenues. But the comprehensive approach that was taken in 1986 act cleaned up a good deal of the unfairness in the income tax; while it did not fully achieve a level playing field, it certainly did improve horizontal equity. Under these circumstances and the fact that our tax rates are now among the lowest in the world, I do not think it would be unconscionable to raise a modest amount of revenue from the income tax.

Let me just add one point. The broadened tax base that you adopted in 1986 is now about $2 trillion under the personal income tax and about a half a billion dollars under the corporate tax. If you raise the individual and corporation income taxes 1 percentage point—the 15 to 16 percent, the 28 to 29, and the 34 to 35—you would raise $25 billion today and over $33 billion 5 years from now. With a three-point increase you could raise $66 billion 5 years from now for a two-point increase and almost $100 billion. Under these circumstances and in light of the unequal distribution of tax burdens in the last two decades, it seems to me that value-added taxation should be rejected.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Pechman appears in the appendix.]

The CHAIRMAN. Thank you.

Mr. Thomas Swanstrom, who is the Chief Economist for Sears, is testifying on behalf of the American Retail Association.

STATEMENT OF THOMAS SWANSTROM, CHIEF ECONOMIST, SEARS, ROEBUCK & CO., TESTIFYING ON BEHALF OF THE AMERICAN RETAIL FEDERATION, CHICAGO, IL

Mr. SWANSTROM. Thank you, Mr. Chairman.

Over the weekend I was asked to testify and since today is my 50th birthday, I thought it an odd choice of birthday gifts. [Laughter.]

The CHAIRMAN. Just lucky, I guess.

Mr. SWANSTROM. In recent years the concept of a value-added tax has often been proposed as a remedy for many of the problems of the U.S. economy. The advocates of a VAT paint the picture that such a tax will magically correct these problems. But in the end what most want simply boils down to some of the money that a VAT would generate.

The savings rate issue has become a straw man for those individuals and groups advocating a value-added tax. In their view, low U.S. savings is an intractable problem that can only be solved if consumption can be discouraged through higher taxes. What they ignore, however, is that any such tax increase would reduce both consumption and savings. In fact, the initial response of consumers to a VAT is likely to be one of maintaining their spending levels by reducing savings. Thus, the savings rate could be severely depressed by a value-added tax. In addition, the fall off in consumption would probably precipitate a recession since consumers would stock up on goods before the VAT was imposed and then cut their spending sharply.

It is often stressed that the prime advantage of a VAT is its enormous potential for raising revenue. We see this cash cow of a VAT as its prime disadvantage. Any tax that can easily generate such large sums would automatically remove much of the spending restraint discipline from the political process.

One of the supposed prime advantages of a VAT is that under the rules of GATT it would be rebatable at the border as an indirect tax. But with a VAT as an add-on tax, there would be absolutely no benefits to the U.S. trade balance. This is because the prices of U.S. exports at the border after the VAT rebate would be exactly the same as they are now. Imports would have a VAT applied at the border, but domestic sales of U.S. manufactured goods would also be subject to the VAT. Thus again, the competitive posture of U.S. goods would be exactly the same as it is now.

Thus, a VAT would not produce what its advocates proclaim, substantially lower deficits, higher savings, and an improved trade balance. In addition, a VAT has other decided disadvantages. For one thing it is very regressive. Small and growing businesses would be hurt badly by the VAT since the taxes would have to be paid even if the companies were unprofitable. For all businesses a VAT would be another enormous administrative burden that the Federal government would require, but not pay for. The government itself would, of course, also have to set up a costly new agency to administer the program. A VAT would also make it much more difficult for State and local governments to raise their own taxes.

But the most onerous aspects of the VAT involve its effects upon the political process. This is because a VAT would not be out in the open like most taxes, but would, instead, be hidden from those who pay it. The result would be that when money is needed for governmental programs raising the VAT would be an easy and painless way for lawmakers to fund them.

We believe that the imposition of a VAT in the United States would be ineffective as a measure to reduce the Federal deficit. Most of the revenues generated would likely be used to fuel spending rather than applied to deficit reduction.

In addition, a VAT would sharply raise the tax burden on the U.S. economy. A five percent VAT, for example, would increase the Federal taxes share of GNP from 20.5 percent to 22.5 percent. Our studies have shown that the implications of such a large tax burden are clear. Economic growth will deteriorate as it has inevitably in the past during similar high-tax periods. For example, when the Federal tax burden reached 21.5 percent of GNP in 1981, it was followed by the 1982 recession.

The high tax level, as well as the sharply negative impact of a VAT on consumer spending, would force the Federal Reserve to step up money supply growth to offset a weakening economy. The indirect effect of easier monetary policy, along with the direct impact of a VAT on prices and cost of living clauses, would then lead to accelerating inflation. In turn, this higher inflation would raise the government's costs for means-tested entitlements and its own purchases. Again, the results are clear. The effects of a VAT in slowing the economy and raising inflation would increase the Federal deficit, not lower it.

How do we escape the treadmill of growing Federal debt without the quick fix of a value-added tax? Put simply, hold down Federal spending. Both the OMB and CBO have projected Federal revenue growth of $80 billion in each of the next 4 years. If only one-half of those revenues were dedicated to reduce the deficit, the Federal budget would be balanced by 1993, and the sizable sum of $40 billion per year would still be allowed to provide new programs or increases for existing ones.

We have developed a similar proposal that allows even more funds free for new initiatives. We recommend that Social Security be excluded from the considerations, and the remaining Federal spending increase in line with the OMB parameters for fiscal 1990. Between 1991 and 1995 spending would then be allowed to grow at the rate of inflation. Such a program would eliminate the deficit by 1995 and result in cumulative savings over this 5-year period of over than one-half trillion dollars in Federal spending.

It is our view that such a spending restraint program is the best way to deal with the Federal deficit problem. Any quick-fix solution using value-added or other taxes would create more problems than it solves. The continuing health of the U.S. economy is heavily dependent upon the tax load on American taxpayers. To keep the United States strong, that tax burden should be lowered, not raised.

Thank you.

[The prepared statement of Mr. Swanstrom appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Swanstrom.

Having Dr. Pechman here and Dr. Cnossen——

Senator SYMMS. Mr. Chairman? Mr. Chairman, excuse me for interrupting, but I am sorry. I have another appointment.

I would just like to ask unanimous consent that my remarks with respect to the estate taxes be inserted in the record at the appropriate place.

The CHAIRMAN. They will be without objection.

Senator SYMMS. I thank all the witnesses, and excuse me, I have to leave.

The CHAIRMAN. Surely.

[The prepared statement of Senator Symms appears in the appendix.]

The CHAIRMAN. Dr. Pechman and Dr. Cnossen, having you both here at the same time leads me to ask the question in light of what you have shown, Dr. Pechman, concerning our top rates and our lowest rates and the highest income people and the lowest income people.

How do we compare with the European Community insofar as the disparity between taxes paid by the poor and by the rich, either of you?

If there is a contrary view, I would like to hear that too.

Dr. **CNOSSEN**. Well, everything and everybody is taxed higher in the European Community than in the United States. The average tax burden——

The **CHAIRMAN**. Everybody what now? Say that again.

Dr. **CNOSSEN**. Everything and everyone is taxed higher in the European Community than in the United States, Mr. Chairman. The average tax burden in the four largest Member states of the European Community, Great Britain, Germany, France, and Italy, averages 45 percent of gross domestic product compared to 30 percent in the United States. In the smaller countries, it is 51 percent.

This implies nearly automatically, I would say, that the income taxes in European countries are substantially higher than they are in the United States. In addition to that, of course, European countries have value-added taxes with rates ranging from 10 percent in Luxembourg to 22 percent in Denmark.

As regards the choice between taxes and what to do with respect to regressive effects on the poor, the tax systems of European countries, in particular, the Northern European countries, have chosen to ameliorate the plight of the poor via the expenditure side of the budget. Translated into U.S. terms, that would mean that means-tested programs like food-stamps, Social Security income supplements, various other entitlements, and possibly also the earned income tax credit, could be used to offset the regressivity of the value-added tax. However, as Dr. Pechman has stated, they would not have that effect for middle-income tax payers.

But obviously the budget deficit itself is also a form of tax, particularly on the middle class, in raising interest rates and in its potential danger for price increases, and these factors must be considered because of their effects on middle-income earnings.

The **CHAIRMAN**. Let me be sure I understand what you are saying.

Are you saying that because of the programs for the poor, in effect there is less disparity between the tax load or the benefits that accrue to the poor and the rich than there is in this country? Is that what you are saying?

Dr. **CNOSSEN**. That is definitely the case. Although the higher taxes in European countries are probably not as progressive, or anyway, not more progressive, than the tax system is in the United States, this is offset, more than offset, I should say, by what is done on the expenditure side of the budget through income support programs.

The **CHAIRMAN**. All right. I am following you fine.

Dr. Pechman?

Dr. **PECHMAN**. Dr. Cnossen is entirely right, but I want to point out that these family allowances or income-tested credits that are given in Europe go primarily to the lowest part of the income distribution. Because of the high value-added taxes—they go as high as 20 percent of consumption—and the high payroll taxes, which are as high as 50 percent in some countries, the rich probably pay much lower taxes than the middle- and the lower-income classes. In other words, their tax transfer system is more progressive at the bottom, but much more regressive at the top than in the United States because of the existence of those high value-added taxes and payroll taxes.

The **Chairman**. Dr. Walker, let me ask you a question that I asked Senator Hollings.

When you stop to think about the problems Nakasone had trying to put in a value-added tax and Prime Minister Takeshita bringing it off, but nevertheless, having a great deal of discontent over it, what do you think the attitude toward a VAT would be here?

Dr. **Walker**. Mr. Chairman, to the best of my knowledge, the attitude toward any tax increase on the part of the American people is quite negative as all the polls show.

The **Chairman**. Sure.

Dr. **Walker**. If, on the other hand, the question is changed a little bit to say if you could be sure that the tax would be used to reduce the deficit, then you begin to get more positive answers. If and when we have reached the point that the people in Washington decide we must move in the tax area with an increase along with spending restraint to deal with the deficit, then we should clearly recognize that the people will have spoken in another way.

If you ask the American taxpayer, "If your taxes have to go up, what sort of tax increase would prefer?"—most recently a Time Magazine poll just a couple of months ago—they favor sales taxes 45 percent—and the value-added tax is a sales tax—26 percent would favor a gasoline tax, and only 15 percent would favor an income tax. The least unpopular tax is the sales tax by three to one, for a variety of reasons. So I would say if and when, and if marketed properly and people are convinced we have to have the tax increase—that is a fundamental point—they would prefer the VAT, if they understood it, over the income tax.

The **Chairman**. Do you have some questions, Senator Daschle?

Senator **Daschle**. Thank you, Mr. Chairman.

I just have a couple.

Dr. Walker, I was listening as you were answering the Chairman's last question with regard to polling. The polls also indicate that, if a tax increase were enacted, there is an overwhelming sentiment in favor of taxing the rich, taxing those with a greater ability to pay. Dr. Pechman indicated that we could increase each one of the upper-level brackets by 1 percent and raise the same amount of revenue that we could with a value-added tax.

Given the polls and given that fact, what would be your response?

Dr. **Walker**. My basic response would be that we have finally got our upper tax rates down to a level that are both fair and also stimulating to work, saving, and investment. So I would not favor that. But as far as the Congress is concerned, I think——

Senator **Daschle**. Let me ask you. Let us just stop there for a second.

You said we have gotten the rates down and that they are fair.

Dr. **Walker**. I think that we have a fair level of top marginal tax rates now as compared to when I came to town. The top rate was

91 percent. President Kennedy and the Congress lowered that to 70 percent. When I was in Treasury we lowered the rate on earned income, so-called, to 50 percent, and in the Reagan Administration, the top rates were cut to 33/28.

Senator **DASCHLE**. Basically, the trend has been that a greater and greater share of the tax burden is on low-income earners.

Would you not agree? I mean, that is not even a——

Dr. **WALKER**. No, sir.

Senator **DASCHLE**. That is a fact. It is not a conjecture.

Dr. **WALKER**. I think you have to take a very hard look at the burden tables to see just how the tax burden has shifted over that time.

Senator **DASCHLE**. It has to shift down. If it is clear that the rich are paying less, somebody is having to pay more; are they not?

Dr. **WALKER**. But lower tax rates help give you a more expansive economy, and a more expansive economy raises incomes and you will find that the rich people are paying more taxes at lower rates then they paid under the taxes with higher rates.

Senator **DASCHLE**. As a percentage of income?

Dr. **WALKER**. No, not as a percentage of income.

Senator **DASCHLE**. That is what we are talking about here, as a percentage of income.

Dr. **WALKER**. If you measure the end-all and be-all of the tax system strictly in terms of the progressivity aspect, number one; if you also say that every tax has to be perfect in and of itself—you see, we have regressive taxes today. If we felt this very strongly, we would get rid of the gasoline tax, the alcohol tax, the tobacco tax, the beer tax, the telephone tax. We have a lot of regressive taxes. And we have a progressive spending system that offsets tax regressivity. But I would say to the Congress and to Mr. Pechman, you can make the VAT like you want it.

We have a personal income tax system. You can take a VAT and combine those two together to produce any reasonable degree of progressivity you want to give. I would do it at the lower income levels with a refundable income tax credit. If you wanted that to be a social program, income supplement, you could double that credit over the amount that would be necessary to offset regressivity. If Congress felt it were necessary to do something at the upper income ranges, which I would despair, but if they did, you can do that. So the VAT per se does not preclude progressivity. You can make the system as progressive as you want in combining the two.

Senator **DASCHLE**. I would have to admit that for me the jury is still out with regard to a value-added tax, but I must say that I think the most damaging argument against a VAT is fairness.

Dr. **WALKER**. That is true.

Senator **DASCHLE**. And I do not think anyone can challenge Dr. Pechman's assertion in that regard. Now, I think Dr. Cnossen did a pretty good job of addressing another element, that is, the ramifications of having a different source of income, and Europe has done that fairly effectively. What you are saying is that, as a result of this new pool of resources, they have been able to dedicate many of those resources directly to advancement of the lower levels of income more effectively than we have.

Is that a correct understanding of what you indicated?

Dr. **Cnossen**. Correct, Senator. I would say that although the European tax systems may be slightly less progressive, I should say, than the U.S. tax system, there is no doubt in my mind, and Dr. Pechman will confirm what I am going to say, that the income distribution in these European countries is more equal than the income distribution in the United States. I think that is fuel for your——

Senator **Daschle**. And the only other argument that I think is worth considering as one considers value added is the real disadvantage we have in the international trading competition today that as a result of not having a value-added tax, I view our country at a very distinct disadvantage. Now I was interested in Mr. Swanstrom's comment that he felt that was not a disadvantage, but could Dr. Pechman or Mr. Swanstrom address that issue?

Dr. **Pechman**. What particular issue do you want me to address?

Senator **Daschle**. Do we not disadvantage ourselves by not having a value-added tax with regard to the importation of foreign product today?

Dr. **Pechman**. Oh, no. I do not think the adoption of a value-added tax would have any effect on our competitiveness or our foreign trade for the reason that value-added taxes are rebated on exports and therefore, the prices of exports remain the same in absolute terms after the value-added tax has been imposed as before.

May I just add one other point to supplement what Charlie Walker said about progressivity. It is true, as he said, that you could couple an increase in the top bracket marginal tax rates, which he opposes, with a value-added tax.

But if you went so far as increasing the top marginal rates, then the question is why do you want to impose a value-added tax and then take it back with a rebate in the lower-income classes? Since the exemptions and standard deductions exempt the poor from the income tax, distribution of the tax burden in the lower- and middle-income classes is automatically progressive as well.

Why go through the hocus pocus of having a new tax if you agree that you have to increase tax rates moderately in the higher-income classes? I would increase it moderately under the income tax in all classes and that would be a progressive tax increase.

Mr. **Swanstrom**. Following up on Dr. Pechman's statements on trade, too, there seems to be a long-standing myth that we need a value-added tax to equalize the international situation in trade, and that definitely is not the case. The value-added tax would simply leave prices higher in the United States for both domestic goods and imported goods. That would be a negative impact, but at the border there would not be any difference.

Senator **Daschle**. Let me just ask you this, and I appreciate the Chairman's tolerance here.

This is a quote of Senator Hollings. I was not here for his testimony, but I have heard him make the argument before.

"A VAT is a border-neutral tax which means that when a good passes out of the country in which it is produced the VAT is rebated to the seller. In addition, when the same product is imported into the country where it is to be consumed, that importing country's VAT is added to the product. So a country without a VAT, like the United States, is getting the worst of both worlds."

Do you challenge that?

Mr. **Swanstrom**. Yes, I do challenge that. For example, in the case of exports, the VAT is rebated at the border, but that will leave the prices of goods exactly where they are now. There is no competitive advantage for exports.

Senator **Daschle**. Dr. Walker?

Dr. **Walker**. Senator Hollings is correct. He is describing the system as is. In 1947 when the general agreement on tariffs and trade was set up, it was said that you could rebate a border tax, which was an indirect tax like a sales tax, but you could not rebate a direct tax, such as the corporate income tax and the payroll tax. Taxes are costs. The bulk of our taxes on business are corporate profits taxes and payroll taxes. They cannot be rebated or added at the border, so we have a substantial disadvantage. Mr. Swanstrom is also correct. Setting up a VAT and then rebating it is not going to do any good. But if you are comparing up a VAT with an income tax increase, or if you set up a VAT and use part of the proceeds to reduce income taxes or payroll taxes, then we are getting a net positive impact in foreign trade. To set up a VAT and rebating it? No, that does not do anything for you.

Senator **Daschle**. Mr. Chairman, I am sure this will not be the last word we hear on this issue I am already way over my time, and I thank you for your tolerance.

The **Chairman**. That is fine.

Come on, Doctor, sound off. Let us hear what you have to say.

Dr. **Pechman**. Mr. Chairman, the statement that was just made that income taxes are costs is just ridiculous. It just does not make any sense. The personal income tax is not a cost of doing business, and I would say that the vast majority of economists—Dr. Cnossen could perhaps comment on this—would say that the corporate tax is a tax on capital. That is why we have a corporate tax, to tax capital. It is not a cost. It does not raise prices. If it was reflected in prices then we should have seen a huge reduction in the price level as a result of the reduction in the corporate tax in 1981; or we should have seen large increases in prices when the corporate tax was increased. There is no evidence from the time series, or from other data, that the corporate taxes are passed on in the form of higher prices, and therefore, the imposition of a value-added tax would not change the competitiveness of U.S. products.

The **Chairman**. Dr. Cnossen, do you agree with that?

Dr. **Cnossen**. Well, I am sitting between my old friend, Dr. Pechman, and a newly-acquired friend, Dr. Walker and I——[Laughter.]

The **Chairman**. Senators have been in that position for years. [Laughter.]

Dr. **Cnossen**. So you have sympathy with me.

What do I think? I think that one would want to ask in this context what other methods would be taken to reduce the deficit, what other tax measures would be taken? Now if you imposed energy taxes or excises, which would enter into the cost of production and not be rebated at the export stage, as most energy taxes are not, then obviously a value-added tax would have an advantage. There is also some evidence that at least part of the corporate tax burden is reflected in consumer prices, and I think Dr. Pechman would not disagree with that.

Dr. PECHMAN. No, I would not agree with that at all.

Dr. CNOSSEN. He would not agree with that at all. [Laughter.]

We still remain friends.

Dr. PECHMAN. That is right.

Dr. CNOSSEN. Payroll taxes would also enter into the cost of products. If they had to be increased to provide more revenue, they would also not be rebated for exports at the border. I think that the value-added tax is the most product-neutral and the most factor-neutral tax that exists, and it is a far better revenue measure looked at from an international point of view than all the other taxes that have been mentioned.

The CHAIRMAN. These experts—I cannot resist—we have a real problem in trying to encourage savings in this country, and we have tried a lot of things. I would like to hear from a couple of you, and I want Dr. Pechman to be one of the two because I think I know where he is coming from on it. What can, if anything, be done through the tax system to encourage savings?

Dr. PECHMAN. It is very difficult to increase saving by tax devices. We have tried it before and failed. I think in present circumstances the way to increase national saving is to eliminate the dissaving at the Federal level. That increases national saving dollar for dollar. We know that that is the case——

The CHAIRMAN. Are you talking about the deficit?

Dr. PECHMAN. I am talking about the deficit.

The CHAIRMAN. All right.

Dr. PECHMAN. Now beyond that, if after we eliminate the deficit, we still think that our saving is inadequate and you wanted to use tax devices, I would say that you would have to design a net saving incentive—not a gross saving incentive like the IRAs—but an incentive that provides tax credits or deductions for people who on balance, save during the year. And that is extremely difficult. So I would say that taxation is not a good means of increasing national saving.

The CHAIRMAN. Dr. Walker, or Dr. Cnossen, either one of you.

Dr. WALKER. Let me say this. Joe and I, and I guess Professor Cnossen—not quite—come from a certain generation of economists who in their training had it drilled into us that saving was not responsive to higher interest rates or lower taxes. The work that has been going on in recent years, Dr. Shoven at Stanford, Dr. Boskin, who is now head of the CEA, Dr. Summers who was Chief Economic Advisor to Mr. Dukakis, Dr. Feldstein and others at the National Bureau of Economic Research, are taking the view that the argument is over, that there is a relationship between the tax burden and the level of saving, and they have empirical studies that point in that direction.

The CHAIRMAN. All right.

Dr. CNOSSEN. Well, both the level of savings and the level of taxation in European countries is much higher than in the United States.

The CHAIRMAN. We understand.

Dr. CNOSSEN. Second, I think I agree with Dr. Pechman that the best way to solve the savings problem in the United States is by closing the budget deficit, which dollar for dollar would add to national savings. As for the choice between increasing income taxes or introducing a consumption tax like a value-added tax, I would like to point out that an income tax favors consumption over saving because it taxes savings twice, whereas a value-added tax is neutral with respect to the choice between saving and consumption. As for the savings issue, I think that is an argument in favor of a consumption tax.

The CHAIRMAN. Mr. Swanstrom.

Mr. SWANSTROM. We have done studies to try to determine what the important factors lying behind savings are. We took everything that has been discussed over time as being predictors of savings. We found there is only one significant predictor and that is demographics, that the demographic trends in this country as the age composition of the population changes will be increasing the savings rate in the United States.

I think too much attention is paid to the savings rate, which is the percentage of income saved each year, and too little paid to the savings stocks, that is, the accumulation of all past savings in this country, the total amount of savings. Saving stocks in the United States are far above those of Japan, and this is because of higher interest rates in this country and the past accumulation of savings here. So I think we should pay more attention to that too.

The CHAIRMAN. I have a hunch that if savings begin to gain that you fellows would just increase your advertising budgets. [Laughter.]

Senator Daschle.

Mr. SWANSTROM. We also own Dean Witter, so we want savings too. [Laughter.]

Senator DASCHLE. Not that CRS is the ultimate source, but of course, their study has indicated there really was not much of an association between a value-added tax and the savings rate—which, again, I would put over in the column of not very compelling arguments for the value-added tax.

But you said something, Dr. Cnossen, that I have never heard before and maybe you can elaborate. You said that by reducing the amount of the deficit, we are automatically going to see an increase in national savings. We have had surpluses in our country in the last 30 years, and we have not seen any real appreciation of savings on the other side.

On what basis do you make that projection?

Dr. CNOSSEN. Well, I think as Dr. Pechman said, that now the savings of the country are being converted into government consumption through the Treasury Bonds that are used to absorb these savings, and if you reduce the budget deficit, obviously these savings would be available for productive investment elsewhere in the economy. I did not say that there was an automatic link between the savings and productive investment, but the amount of foreign investment that is flowing into the United States illustrates that this is a very attractive country for foreign investors.

Senator DASCHLE. What you are saying is that it creates a pool for savings——

Dr. CNOSSEN. It does, yes.

Senator DASCHLE [continuing]. Which could be dedicated to consumption. We have no assurance that it would be savings.

Dr. CNOSSEN. That is correct.

Senator **Daschle**. All right.

Thank you, again, Mr. Chairman.

Dr. **Walker**. Can I?

The **Chairman**. Yes.

Dr. **Walker**. One quick comment referring to what Senator Daschle said. During the period when we did have much lower deficits or surpluses from time to time and the national savings rate was close to nine percent. Recently it has been closer to three percent. So we do have that very big difference. On the CRS study that looked only at the impact of the tax itself on savings, not at the impact of using the tax to reduce the deficit which would be the major short-run impact on the savings rate, deficit reduction, not the tax per se.

The **Chairman**. Gentlemen, this discussion has been extremely interesting and it shows how easy the job is for us in trying to decide.

Thank you very much.

Our next panel is Mr. Roy Nyberg, who is speaking on behalf of National Retail Hardware Association, Sioux Falls, South Dakota; Mr. Richard Dees, who is a partner in McDermott, Will & Emery; Professor Gutman, who is Professor of Law, University of Pennsylvania.

Senator **Daschle**. I want to welcome to the committee our panel. In addition to those who are going to present their testimony this morning, the committee is also particularly appreciative to have present David W. Loving, the Managing Director of the National Retail Hardware Association. I understand that Mr. Loving has requested that Mr. Nyberg present the views of the National Retail Hardware Association, but we are delighted to have him here and, if he has any additional comments at the end of the presentation, we are more than willing to take them.

Mr. Nyberg, since you are my constituent, and I am delighted to see that you are here, and since we have talked about this issue on numerous occasions, I would like to ask you to present your testimony, and then we will move to Mr. Gutman and Mr. Dees.

STATEMENT OF ROY D. NYBERG, NATIONAL RETAIL HARDWARE ASSOCIATION, SIOUX FALLS, SD, ACCOMPANIED BY DAVID W. LOVING, MANAGING DIRECTOR, NATIONAL RETAIL HARDWARE ASSOCIATION

Mr. **Nyberg**. Thank you, Mr. Chairman. Members of the Senate Finance Committee, I would like to thank you for allowing me to appear before you today.

My name is Roy D. Nyberg and I am the owner of Nyberg's Ace Hardware, Inc. of Sioux Falls, South Dakota. As Senator Daschle has mentioned, I have David W. Loving representing the National Retail Hardware Association and its 18,000 members across the nation. I would like to testify both on behalf of myself and all of the family hardware store owners confronting problems with tax code provisions concerning estate transferal.

As a hardware store owner, I am certainly no expert on the intricacies of the Internal Revenue Code. I pay my taxes, see an accountant when I have to, and hope that the laws passed here in

Washington do not interfere with my business. Section 2036(c) of the Internal Revenue Code, however, threatens to choke the very lifeblood of family businesses and gradual transfer from generation to generation.

When I started working in a hardware store in 1942, it was my ambition to operate a family business. By 1958, after working long hours and learning the business, I was able to start Nyberg's Ace Hardware in Sioux Falls. Then I only had 4,000 square feet of space and average sales of $35,000 a year.

During the next 30 years, I carefully built up my business, looking forward to the day when I could turn it over to my son. The business steadily grew with a combination of sweat equity, returned capital, the right decisions, and good fortune. Today Nyberg's Ace Hardware, Incorporated, is a more sophisticated operation with annual sales of close to $2.5 million. I have realized part of my dream. I am now 63 years old and quite ready to pass along control of the operation to my son, Kevin, who is now 32 and holds a college degree in business management.

As far back as 1977 I was concentrating on transferal of family businesses. During my first year in the National Retail Hardware Association's Board of Governors, I successfully spearheaded a project researching options available to store owners. The end product of this effort, the book "Who's Next, Please?," was published in 1982 and has guided many hardware transitions.

For me and thousands of other small businessmen like me, the other half of this dream is to pass on the fruits of my labor to our children. Unfortunately, it is not that simple. My accountants and lawyers tell me that if I give to Kevin an interest in the store, which would entitle him to the benefit of the future growth in the enterprise, the IRS may assess my estate for taxes as a result of Internal Revenue Code, Section 2036(c). These taxes, I am told, will reflect the entire value of the business at transferal. In essence, from the tax perspective alone, it has become advisable for me to sell Nyberg's Ace Hardware, Incorporated, to a competitor rather than to my own son.

I want to explain to you the dynamics of Nyberg's Ace Hardware so that you will understand why I cannot simply give it to my son and retire. While my son has competently taken over much of the day-to-day operation of the store, my participation continues to be essential in several areas. Of these areas, the most critical involves our accounting system. We began transferring inventory and accounting systems to the computer last year. It has been a difficult process and will take 2 to 3 years to complete, and only my 30 odd years of institutional knowledge of this business can efficiently provide the answers to the thousands of questions that come up. These situations highlight the advantage gained by supplementing Kevin's youth and vigor with my skill and knowledge. It just makes good business sense.

Before 1987 many of my peers entered into transactions which are now discouraged under Internal Revenue Code, Section 2036(c). By gifting all of the future appreciation of their businesses through an estate valuation freeze, they were able to include their sons and daughters into the business. By wisely retaining some of the control of their business' operation, they allowed for a gradual transition in order to ensure that the business remained profitable. They realized, as I do, that there is no single point in time when you achieve full competence and wisdom. Learning the hardware business is a gradual process, and responsibilities and control of the business should increase as you learn. It would be unwise to structure the transfer any other way.

By adding Section 2036(c) to the Tax Code as part of the 1987 Revenue Act, Congress prohibited me from using the same flexibility in my estate planning. If I transfer my business today, I will not be able to retain any interest from the standpoint of control in my hardware store. If estate taxes have to be paid to transfer the store, my executor may be forced to liquidate critical assets to pay taxes. Why must a healthy, dynamic enterprise be crippled to be transferred?

Mr. Chairman, I am not against paying my taxes, and I am sure that there are some types of abusive estate planning practices that give rise to Section 2036(c). But many legitimate transactions, such as the transfer of my business to my son, are treated under the Tax Code as if they were abusive. Section 2036(c) places unfair restrictions upon the closely-held businesses that make up the backbone of America.

While I do not have all the answers concerning this issue, I would like to make two suggestions. First, I would like to urge the committee to reaffirm the importance of family-owned businesses by passing Senator Daschle's bill repealing Section 2036(c). Second, I would like to volunteer myself and my association to participate in an ongoing dialogue with the committee concerning appropriate regulations of estate planning practices.

Thank you.

[The prepared statement of Mr. Nyberg appears in the appendix.]

Senator **Daschle**. That is great timing.

Mr. Dees.

STATEMENT OF RICHARD L. DEES, PARTNER, McDERMOTT, WILL & EMERY, CHICAGO, IL

Mr. **Dees**. Good morning, Senators.

I am Richard Dees, a partner in the Chicago Estate Planning Department of McDermott, Will & Emery, a national law firm. I have been invited today to express my personal views on the repeal of Section 2036(c).

A simple example will show how Section 2036(c) attacks freezes and why it should be repealed. A child graduates with a Ph.D. in English. The parent loans child a typewriter, perhaps one that has been in the family for a number of years. The child writes the Great American Novel on that typewriter. These book rights will bring a million dollars a year in royalties. But parent dies and the IRS claims child owes 55 percent estate tax on top of the income tax child pays on the royalties.

In our example all of the capital in this enterprise of book writing was attributable to the parent. Thus, under Section 2036(c) the entire value of the book rights could be taxed in the parent's estate. The child's efforts are disregarded.

While this admittedly is an extreme application of Section 2036(c), it is not that much different than how it applies in a real family business. Parents have capital and experience. Children have ideas and energy. 2036(c) starts from the premise that all the appreciation in the stock is attributable, or could be attributable to the parents' efforts, and therefore, it is fair to disregard the child's efforts.

Family business succession ought to be encouraged as long as a parent is adequately compensated for the services provided and receives a market rate of return on the capital invested in the business. Under those circumstances the appreciation ought to be shifted to the child donee.

As Treasury testified, there are other reasons besides the allowance of this legitimate planning device to repeal 2036(c). As they said, it is overly broad and practically impossible to apply.

Second, it targets only family business owners. This places family businesses at a competitive disadvantage when compared to multinational or publicly held corporations. This discrimination is most evident in applying to fair-market value purchases of business interests by family members.

The response to all of these criticisms was to enact statutory safe harbors in the 1988 Technical Corrections Act. A safe harbor is a narrow exception to 2036(c) into which all family business transactions must fit. This approach to narrowing the application of 2036(c) is the equivalent of me telling someone how to get to my house by describing everywhere in America that I do not live. No matter how well traveled I am, I am bound to miss something in that description, and the people who write these safe harbors are not well traveled in the business world.

A safe harbor sounds like something friendly and inviting, a well-lit port. Safe harbors under Section 2036(c), on the other hand, are more like rocky fiords or slippery sandbars. To illustrate that point, I have had two charts prepared. I tried to get it on one chart and I have one behind the other, but the chart illustrates one of the safe harbors in the statute for qualified debt. This is the safe harbor that one has to meet if a parent wants to loan money to a child to buy a house or sell a family business or farm to the child on installments. As you can see, it is quite lengthy and complicated.

You might think that all the parent had to do was to use commercially reasonable terms and a fair-market interest rate. But that is all that applies to other people, not family members when they go into their transaction. That is in a different Code section, 7872, and family members must not only meet that test, but the list of tests here that apply. This safe harbor should be distinguished from the statutory safe harbor for start-up debt. That is an entirely different part of 2036(c). That safe harbor goes to the issue of a parent providing seed money for a child to start his or her own business. One of the requirements of that safe harbor is that the parent cannot then refer customers or clients to the child's business. That does not seem fair.

It seems that 2036(c) is being used to attack the problem of unequal parentage. If we are going down that road, where 2036(c) is to be used to tax nonmonetary transactions, we might as well tax

Richard Daly's estate for his son's election as mayor. No one is suggesting that that is going happen. Instead, we are targeting family business for this experiment.

One of my clients, who is a farm owner and a wife of a doctor in downstate Bloomington, Illinois, best summed up the problems with 2036(c): "You know, taxpayers," she said, "ought to be able to go about their businesses without worrying that 2 years later the IRS will decide something they did earlier was wrong." We ought not be second guessing taxpayers.

Unfortunately, I am afraid that the notice which has been promised so long and has not been forthcoming is going to be about 45 more pages of these safe harbors, and that is not going to be helpful to family businesses.

Senators, it ought to be possible to make laws, even tax laws, understandable to farmers and small businessmen who are supposed to be subject to them without notices, regulations, committee reports, floor colloquies, and yes, even Chicago lawyers.

Thank you.

[The prepared statement of Mr. Dees appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Dees.

Mr. Gutman.

STATEMENT OF HARRY L. GUTMAN, PROFESSOR OF LAW, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Professor GUTMAN. Thank you, Senator Daschle.

Section 2036 has been described as anti-family. We are told that unless the Section is repealed, small business as we know it today is going to disappear.

These assertions are made principally by the affected constituencies in the estate planning bar. Taxpayers used to paying little or no tax on transactions quite predictably object when they are suddenly treated like everybody else. Many estate planners like to retain the tax preferences that benefit their clients. It gives them something to market. Consequently, these prophesies about the effects of this provision ought to be viewed with some skepticism. Indeed, I might be cynical, Senator, but I suspect that these extravagant claims are more likely indicative of the fact that Congress has discovered some tax-avoidance practices that practitioners and beneficiaries have come to view as their entitlement.

While as currently drafted, Section 2036(c) is ambiguous and susceptible to overbroad interpretation, it is nonetheless responsive to a series of avoidance techniques that aggressive estate planners have exploited with great success over the years. Congress is entirely correct in trying to curb these avoidance devices. Section 2036(c) ought to be refined and not repealed.

Section 2036(c) has been described as an anti-freeze provision, but there is considerable uncertainty as to its scope. It seems to me that it is useful to take a couple of minutes to identify the types of avoidance devices to which it ought to be addressed.

But first, let me say a word about Mr. Nyberg's problem. You know, I do not really think Mr. Nyberg has a problem. There is nothing in Section 2036(c) that stops Mr. Nyberg from recapitalizing his corporation to have both non-voting and voting common stock and then transferring the non-voting common stock to his child, thereby getting that appreciation out of his estate. As I understand the statute, it would not apply to that situation. What Mr. Nyberg cannot do is freeze the value of the retained interest in his estate and transfer all of the subsequent appreciation. It seems to me that there may be some ways that have not been explored that might be helpful to Mr. Nyberg.

Now Mr. Trier in his prepared testimony talked about the classic estate freeze, and I do not want to go over that. I think we all know what that is. Some have asserted that Section 2036(c) was intended to apply only to that type of recapitalization. That assertion, made by some, is premised on the notion that the description in the legislative history of the classic recapitalization means that only that particular transaction, and not any other that has the same effect, was meant to be covered by the section. The classic recapitalization is not the only way that estate freezes can be accomplished. Members of the staff knew that and members of the committee, I assume, knew that as well. Frankly, Senator, it is almost insulting to suggest that Congress would draft legislation targeted only at one form of transaction when it was aware that many other forms were available to achieve exactly the same result. If the result is to be proscribed, all forms that reach that result must also be proscribed.

I want to give you one example of a different kind of situation. Mr. Dees has made much of the fact that this section is targeted simply at small business. Let us look at an example that has nothing to do with small business at all. It has to do with the use of recapitalization-type device to freeze the value of a major publicly held corporation.

Mr. X owns 20 percent of the common stock and preferred stock of a public company. At market prices the stock is worth approximately $8 million. Mr. X forms a new corporation, exchanges his stock in the public company for non-voting preferred stock of Newco with a liquidating value of $6.9 million and a noncumulative six percent dividend preference. Then each of Mr. X's children for $500 purchases one-half of the common stock. Mr. X maintains voting control through a complicated series of arrangements that really are not material here.

This is an actual case of which I am aware. No gift was reported at the time the new corporation was incorporated because Mr. X took the position that due to blockage factors, the stock he transferred, worth $8 million on the market, was not worth in excess of $6.9 million and that the preferred stock that he received, noncumulative, 6 percent preferred, was worth $6.9 million. The Internal Revenue Service, of course, does not find out about this because no gift tax return is filed.

Three years later the assets of Newco were sold for $28 million. X received the $6.9 million to which he was entitled and roughly $21 million was split between his two children. X managed to transfer that $21 million to his children without the payment of any transfer tax. If Section 2036(c) had been in effect, that transfer would have been subject to tax.

Now, notice that Section 2036(c) does not prohibit this transaction. It does, however, assure that tax is paid when the wealth is transferred. Moreover, and this is particularly important, the transaction I have just described, which involved big dollars, Senator, was not a closely held business. If Section 2036(c) is repealed, these transactions are going to start to spring up again all over the place.

There are other similar kinds of transactions. I buy-sell agreement, as I have said in my statement, can have exactly the same kind of effect. A buy-sell can serve very legitimate business purposes, to be sure. But when it acts as a means of transferring wealth without the payment of tax, then it has to be proscribed.

There are other things that I could say about this. They are in my statement, Senator, and I will be happy to take any questions.

Thank you.

[The prepared statement of Professor Gutman appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Gutman.

I am about a quarter of an hour late to another appointment, so I, too, am going to have to excuse myself in a moment, but let me ask the panel this.

We have all talked about confusion over the estate freeze provisions. Even Mr. Gutman alluded to the fact that there may be some ambiguity in the law that ought to be addressed. Mr. Nyberg and Mr. Dees both have indicated they would like outright repeal.

If we failed to accomplish repeal, at the very least, I think there is one point of unanimity here and that is that the provision needs to be changed. The degree of change is what we are talking about. Mr. Gutman's advocacy for change is much more reserved than Mr. Nyberg's and Mr. Dees'. But I would like from each one of our panelists some specific recommendations with regard to how you would like to see it changed if repeal is not to be considered.

Frankly, I do not know whether, as the sponsor of the repeal language, whether or not I can get repeal at any time in the foreseeable future. But, at the very least, I think it needs reform, and I would really like each one of our panelists to describe that reform as they see it, and I would like that submitted to the committee before the end of the week.

[The information appears in the appendix.]

Senator DASCHLE. I want to thank each of our panelists a great deal for their contribution. Their testimony will be shared, I can assure you, with the rest of the committee members. This is a very busy day on the floor, as well as with other committees.

Senator Heflin wanted to be here. He is a cosponsor of my legislation and has a statement that he wants submitted for the record. So without objection that will be done.

[The prepared statement of Senator Heflin appears in the appendix.]

Senator DASCHLE. Again, let me thank our panelists, and the committee is adjourned.

My apologies to Dr. Rosser. I thought this was the last panel, and I offer my profuse apologies.

STATEMENT OF RICHARD F. ROSSER, Ph.D., PRESIDENT, NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES, WASHINGTON, DC

Dr. **Rosser**. That is perfectly all right, Mr. Chairman. I understand and we will do this very quickly. You have my testimony.

Senator **Daschle**. I do?

Dr. **Rosser**. So just let me summarize a few points.

First of all, we were absolutely delighted with the action last year to pass the Educational Saving Bond. We think it is extremely important, innovative, and a very, very good first start, and I know I speak for many millions of Americans. All of the polls I have seen in the last year or so where people in general are asked, "What are your national priorities?" They list medical care and helping kids finance college. Those are the two things that are right up on the top.

And I think this problem was pointed out beautifully in a little article in the Wall Street Journal just this Monday where the American College Testing Service now suggests—well, they are really predicting—that for a family to send one son or daughter to a 2-year public college without financial aid, that family has to have an adjusted-gross income of $50,000 minimum. That is just to a 2-year college.

If they are going to a private university, they need $95,000. And then, if you look at how many sons or daughters are coming out of families with above $50,000, you are only talking about 18 percent of the 18-year olds and younger in this country. That shows the dimension of the problem.

Now we know that Federal aid per student has been cut in terms of the Pell grants in particular. We know that we have seen a shift from grants to loans, and meanwhile, our independent colleges and universities—and I represent all the independent colleges and universities in the country—we have increased the institutional aid that we are giving from $900 million collectively in 1979 to probably about $3.5 billion this year. And if you want to know why prices are going up at private colleges and universities, much of that has to do with the fact that we are trying to keep these colleges accessible to all kinds of students.

So therefore, I think what we have to do is to help the American public begin to save and begin to save early and to save for something which is specific, and in contrast to what we have heard earlier here today, I really think that over the years we are going to see a net increase in savings as a result of that. And that in turn is why I think S. 353 would be so important. Whether you can do it this year, I do not know.

We have to expand the kinds of people who can save, grandparents, certainly. I think it is really a tragedy that, let us say, a young boy or girl working on a paper route cannot buy one of these savings bonds. Of course, they can give the money to their parents, et cetera. We can do it that way. But we need to think through ways to expand savings and to really help people to finance higher education, which, if this country is going to go any place, we have to have that. If we are going to do that, I really think we ought to press ahead with this Education Savings Bond and seriously consider S. 353 in that regard.

Thank you very much.

[The prepared statement of Dr. Rosser appears in the appendix.]

Senator DASCHLE. Dr. Rosser, let me just ask you one question. Do you think that the Federal plan, as you see it today, will complement the current State plans, or are they somehow in competition with those State plans?

Dr. ROSSER. I think, obviously, some parents are going to say, "Should I save through the State, or should I save through the Federal Government?" I think what you are going to find more and more people over the years taking out education savings bonds because this maximizes the choice, whether a son or a daughter, and although the various State programs say that you can use some of this money if you go out of State, nevertheless, I think that probably what it does is to limit the thinking of people very early, and of course, our concern is it really tends to limit their thinking to attending just the State school within a State and sometimes not even the private colleges or universities.

Senator DASCHLE. Very well.

Again, my apologies for cutting you short, and I appreciate very much your patience in waiting this long to testify here. Your entire statement will be part of the record and your presence here is deeply appreciated.

Dr. ROSSER. Thank you very much.

Senator DASCHLE. Thank you.

The hearing will now stand adjourned.

[Whereupon, at 12:20 p.m., the hearing was concluded.]

APPENDIX

ALPHABETICAL LISTING AND MATERIAL SUBMITTED

(SUBMITTED BY SENATOR LLOYD BENTSEN)

[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS: S. 353 (EDUCATIONAL SAVINGS BONDS); S. 442 (VALUE ADDED TAX); S. 659, S. 838, S. 849 (ESTATE FREEZES); AND S. 800 (MORATORIUM ON CERTAIN STATE TAX LAWS)

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MAY 17, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on May 17, 1989, on tax bills relating to (1) educational savings bonds (S. 353, Senators Exon, Shelby, DeConcini, Harkin, and Lieberman); (2) value added tax (S. 442, Senator Hollings); (3) estate freezes (S. 659, Senator Symms, S. 838, Senator Heflin, and S. 849, Senators Daschle, Heflin, Boren, and Symms); and (4) moratorium on certain State tax laws (S. 800, Senators Bradley, Lautenberg, Dodd, and Lieberman).

Part I of the pamphlet [1] is a summary of the bills. Parts II–V provides a description of the bills, including present law and effective dates. Part II describes S. 353; Part III describes S. 442; Part IV describes S. 659, S. 838, and S. 849; and Part V describes S. 800.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Bills: S. 353 (Educational Savings Bonds); S. 442 (Value Added Tax); S. 659, S. 838, S. 849 (Estate Freezes); and S. 800 (Moratorium on Certain State Tax Laws* (JCS–11–89), May 11, 1989.

I. SUMMARY OF THE BILLS

S. 353: Educational Savings Bonds (Senator Exon and Others)

Interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income, if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year. The exclusion is available only to taxpayers age 24 years or more at the time of bond purchase. "Qualified higher education expenses" are limited to tuition and required fees paid for the attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible institution.

S. 353 (introduced by Senators Exon, Shelby, DeConcini, Harkin, and Lieberman) would allow the exclusion of U.S. savings bond interest when the taxpayer pays tuition and required fees of any individual at an eligible educational institution. The bill no longer would limit the provision to payments of qualified expenses for the taxpayer or the spouse or dependents of the taxpayer.

S. 442: Value Added Tax (Senator Hollings)

S. 442 (introduced by Senator Hollings) would amend the Internal Revenue Code to impose a 5-percent value tax (VAT), effective for transactions occurring after December 31, 1989. The bill would provide a trust fund in the Department of the Treasury restricting the use of the revenue from the VAT to deficit and debt reduction.

S. 659 (Senator Symms), S. 838 (Senator Heflin), and S. 849 (Senators Daschle, Heflin, Boren, and Symms)

Estate Tax Inclusion Related to Valuation Freezes

Under the Omnibus Budget Reconciliation Act of 1987, the value of certain property transferred pursuant to a valuation freeze is includible in the decedent's gross estate. The bills (S. 659, S. 838, and S. 849) would repeal this treatment retroactively from OBRA's enactment (i.e., property transferred after December 17, 1987).

S. 800: Moratorium on Certain State Tax Laws (Senator Bradley and Others)

New York State recently adopted legislation that requires nonresidents to pay income tax on their New York-source income based on the tax bracket they would be in if all of their income were New York-source. Prior to the legislation, nonresidents' tax brackets were determined solely by reference to their New York-source income.

S. 800 (introduced by Senators Bradley, Lautenberg, Dodd and Lieberman) would temporarily suspend the effect of this law and any State legislation enacted in response to the New York law. In addition, the bill would establish a commission to study all such legislation.

II. DESCRIPTION OF S. 353: EDUCATIONAL SAVINGS BONDS

Present Law and Background

Section 135 was added to the Internal Revenue Code by the Technical and Miscellaneous Revenue Act of 1988. This section provides that interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income, if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[2]

The exclusion from gross income of interest on U.S. Series EE savings bonds is available only to taxpayers who are issued such bonds after having attained age 24.[3] During the year the bond is redeemed, the taxpayer to whom such bond was issued must pay "qualified higher education expenses," meaning tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible educational institution.[4] A taxpayer cannot qualify for the interest exclusion by paying for the education expenses of another person (such as a grandchild or other relative) who is not a dependent of the taxpayer.[5]

The exclusion provided by section 135 is phased out for certain upper-income taxpayers. A taxpayer's AGI for the year the bond is redeemed (not the year the bond was issued) determines whether or not the phaseout applies. For taxpayers filing a joint return, the phaseout range is for AGI between $60,000 and $90,000.[6] For single taxpayers and heads of households, the phaseout range is for AGI between $40,000 and $55,000.[7] The phaseout rate for the exclusion is applied gradually over the income phaseout range, as is the case with other income phaseouts provided for by the Code.[8]

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[2] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses, then the amount of excludible interest is determined by multiplying the total interest received by a fraction, the numerator of which is the amount of qualified education expenses and the denominator of which is the sum of principal and interest on all Series EE bonds redeemed by the taxpayer during the taxable year (sec. 135(b)(1)).

[3] Section 135(c)(1)(B). The exclusion will not be allowed if bonds are purchased by a parent (or other relative) and put in the name of a child or other dependent who is under the age of 24 at the time of purchase.

[4] Eligible educational institutions are defined in section 1201(a) and 481(a)(1) (C) and (D) (i.e., nursing schools) of the Higher Education Act of 1965, as in effect on October 21, 1988, and in the Carl D. Perkins Vocational Education Act (subparagraph (C) or (D) of sec. 521(3)), as in effect on October 21, 1988. An eligible educational institution does not include proprietary institutions.

"Qualified higher education expenses" do not include expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program (sec. 135(c)(2)(B)).

[5] For purposes of section 135, a "dependent" is any person as to whom the taxpayer is allowed a personal exemption deduction under section 151.

[6] Married taxpayers (within the meaning of sec. 7703) who file separate returns are not eligible for the exclusion under section 135 (sec. 135(d)(2)).

[7] Section 135(b)(2). The phaseout ranges will be adjusted for inflation beginning in 1990. Such adjustments will be rounded to the nearest $50.

Generally, all Series EE savings bonds can be purchased through payroll savings plans, at most commercial banks, at many savings and loan associations, and at other qualified financial institutions. Such bonds can be purchased in various denominations, ranging from $50 to $10,000. The purchase price is one-half the denomination (or face value) of the bond. In any one year, a person may purchase Series EE savings bonds with denominations (or face value) totalling up to $30,000. The interest rate on Series EE savings bonds varies, depending on how long the bonds are held. The interest rate on such bonds held for more than five years is based on the market rate for Treasury outstanding obligations with five years to maturity. Bonds held for less than five years earn interest on a fixed, graduated scale. Interest earned on Series EE savings bonds is paid when the bonds are redeemed.[9]

Explanation of the Bill

S. 353, introduced by Senators Exon, Shelby, DeConcini, Harkin, and Lieberman on February 7, 1989, would amend the term "qualified higher education expenses" under section 135 to include tuition and required fees paid by a taxpayer for the enrollment or attendance of *any* individual at an eligible educational institution.

Thus, under S. 353, if a person (who is at least 24 years old) purchases a Series EE savings bond after December 31, 1989, interest earned on that bond would not be subject to Federal income tax if, during the year the bond is redeemed, the purchaser pays for qualified education expenses of any individual (e.g., a relative who is not a dependent of the purchaser), provided that such education expenses paid by the purchaser exceed the proceeds (principal and interest) received upon redemption of the bond and the purchaser's AGI for the year of the redemption is below the phaseout range provided for by section 135(b)(2).[10]

Effective Date

The bill would apply to U.S. Series EE savings bonds issued after December 31, 1989.

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[8] For example, if taxpayer filing a joint return has a AGI of $75,000, then the interest exclusion otherwise provided for by section 135 would be reduced by one-half (($75,000–$60,000)/$30,000).

[9] *See* Congressional Research Service, *Saving for College with Education Savings Bonds*, March 22, 1989, pp. 3–6.

[10] In contrast, present-law section 135 provides that interest on Series EE savings bonds is excludible from income only if, during the year the bond is redeemed, the person to whom the bond is issued pays tuition or required fees for his or her own education, or for the education of a spouse or dependent. Under current law, a taxpayer who pays for education expenses of another individual who is not a spouse or dependent would not be eligible for the interest exclusion provided for by section 135.

III. DESCRIPTION OF S. 442: VALUE ADDED TAX

S. 442, introduced by Senator Hollings on February 23, 1989, would amend the Internal Revenue Code of 1986 (the Code) to impose a 5-percent value added tax (VAT) (title I). The bill also would establish a trust fund in the Department of the Treasury that would restrict the use of the revenues from the VAT to deficit and debt reduction (title II).

A. Description of Tax Provisions (Title I of the Bill)

Imposition of the value added tax

In general, the bill would impose a VAT on the sale of property and the performance of services in the United States pursuant to a commercial transaction. In addition, a VAT generally would be imposed upon any sale or leasing of real property and any importing of property, whether or not pursuant to a commercial transaction.

The amount of tax generally would be 5 percent of the value of the property sold or the services performed and would be imposed on the seller at each stage of production and distribution, including the retail stage. Each taxable person in the production and distribution chain would receive a credit for the VAT previously paid by its suppliers on its purchases of goods and services in taxable transactions. Thus, each taxable person generally would pay a net tax equal to 5 percent of the value added by that person to property or services sold. The total VAT paid with respect to any property or service provided to a consumer (taking into account the net taxes levied at all stages of production) would equal 5 percent of the retail value of the property and services.

Taxable persons

The VAT would be imposed on persons who engage in taxable transactions. Taxable persons generally would include corporations, persons engaged in business transactions, sellers and lessors of real property, and importers.

In general, in the case of a sale of property in the United States, the VAT would be imposed on the seller. For property imported into the United States, the VAT would be imposed on the importer. In the case of the performance of services in the United States, the VAT would be imposed on the service provider. However, an employee would not be subject to the VAT with respect to activities engaged in as an employee.

Taxable amount

In the case of cash transactions, the amount subject to the VAT would be the price charged to the purchaser of the property or services, including all invoiced charges for transportation and other items payable to the seller, but excluding the VAT and any State and local sales and use taxes. In the case of any exchange of property or services, the taxable amount would be the fair market value of the property or services transferred by the taxable person.

In the case of imports, the taxable amount would be the U.S. customs value plus the U.S. customs duties. If there is no specified customs value, the taxable amount would be the fair market value of the property.

The bill would provide a special rule for the determination of the taxable amount for sales of certain used consumer goods. If a taxable person sells tangible personal property that was acquired in a nontaxable transaction from an ultimate consumer, the taxable amount would be reduced by the amount paid for the property by the taxable person.

Exceptions to imposition of the VAT

The bill would provide various exceptions to the imposition of the VAT. For instance, the bill would impose a zero tax rate [11] with respect to certain sales of food, housing, and medical care. A zero rating would also be provided for farmers, fishermen, mass transit services, exports, interest, and certain transactions with governmental entities and section 501(c)(3) organizations.

The bill also would provide a *de minimis* exemption from the VAT that may be elected by certain small businesses.

Special rules and treatment of certain transactions

The bill would provide special treatment with respect to the personal use of business property by any owner of the taxpayer, gifts of business property or services, the disposition of nonbusiness real property, and insurance.

Coordination with the Federal income tax system

Under the bill, the basis of any property for Federal income tax purposes would not include the portion of the purchase price that represents a creditable VAT. In addition, the amount allowed as an income tax deduction for any VAT would be determined without regard to any VAT credit. For purposes of computing percentage depletion, gross income would be reduced by the amount of VAT imposed and taxable income would be determined without regard to any deduction allowed for the VAT.

The VAT credit

A taxable person would be permitted to claim a credit for the VAT paid on its purchases of property and services to the extent such property and services are used in a business. The VAT credit would be applied first to reduce the VAT liability, with any excess treated as a refundable overpayment of tax. Generally, in order to claim a credit, the taxable person would be required to have an invoice that indicates the amount of VAT paid.

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[11] In a zero-rated transaction, a rate of 0 percent is substituted for the normal VAT rate of 5 percent.

VAT administrative procedures

The "credit-invoice" method

The VAT system imposed by the bill would utilize the "credit-invoice" method. Thus, any taxable person engaged in a taxable transaction would be required to give the purchaser a tax invoice with respect to the transaction if the taxable person has reason to believe that the purchaser is a taxable person. The invoice would be valid only if it indicated the name and identification number of the seller, the name of the purchaser, the amount of VAT imposed on the sale, and certain other information.

The invoice generally would be required to be furnished no later than 15 business days after the tax point of the taxable transaction. The tax point would be the earlier of (1) the time that the taxable person must recognize income from the transaction for Federal income tax purposes, or (2) the time that payment is received. In the case of imported property, the tax point would be when the property is entered, or withdrawn from warehouse, for consumption in the United States.

Time for filing return and claiming the credit

The bill would require the taxable person to file a VAT return during the first month following the close of the taxable period. The taxable period generally would be a calendar quarter. The return would reflect the VAT due on taxable transactions having a tax point within the taxable period.

To the extent provided in regulations, monthly deposits may be required for the estimated VAT liability for any taxable period.

A VAT credit with respect to a taxable transaction would be allowed no earlier than the first taxable period by the close of which the taxable person has paid or accrued the VAT liability and has received a VAT invoice.

Treatment of related businesses

To the extent provided in regulations, a taxable person would be allowed to elect to treat all businesses under common control (as defined by section 52(b) of the Code) as one taxable person for purposes of the VAT. However, for purposes of the small business exemption, all businesses under common control would be considered one taxable person.

To the extent provided in regulations, a taxable person would also be allowed to elect to treat any of its divisions as separate taxable persons.

Treasury notification and regulations

The bill would require a taxable person to notify the Internal Revenue Service if certain events occur. The reportable events would be described in Treasury regulations and generally would include a change in the form of a business or any other change that would affect VAT liability, a VAT credit, or VAT administration with respect to the business.

The bill also would grant the Secretary of the Treasury broad authority to issue regulations with respect to the VAT.

Effective date

The bill would apply to transactions occurring after December 31, 1989.

B. Allocation of Revenues from Value Added Tax (Title II of the Bill)

The bill would establish a Deficit Reduction Trust Fund (DRTF) in the U.S. Treasury. Amounts equivalent to current estimates of receipts from the VAT would be transferred monthly from the General Fund in the Treasury to the DRTF. Correcting adjustments to these amounts would be made subsequently as more accurate information became available.

Amounts in the DRTF would be used solely to retire outstanding public debt obligations of the United States and to pay any administrative costs incurred in collecting the VAT and in operating the DRTF. Debt would be retired by paying off obligations at maturity, or by redeeming or buying obligations before maturity and retiring them (i.e., obligations redeemed from the public before maturity could not be resold to the public).

For purposes of calculating the maximum deficit amount under the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), amounts received in, and disbursed from, the DRTF would not be included in total revenues and budget outlays. Consequently, VAT receipts could be used only to retire outstanding debt obligations and could not be used to finance current expenditures.

C. Analysis of Specific Issues

1. Definitions of taxable transactions and taxable persons

a. In general

Under the bill, the VAT would be imposed on each taxable transaction. The term "taxable transaction" means (1) the sale of property in the United States, (2) the performance of services in the United States, and (3) the importing of property into the United States, by a taxable person in a commercial-type transaction. A "commercial-type transaction" would mean a transaction engaged in by a corporation (other than an S corporation) or by any other person engaged in a business. Commercial-type transactions also would include any sale or leasing of real property or any importing of property, whether or not engaged in by a corporation or in connection with a business. Importing of articles by a consumer free of duty under the personal exemptions of the United States Tariff Schedules would not be subject to the VAT.

"Taxable persons" would mean persons who engage in a business or in a commercial-type transaction. The term "business" would include a trade and an activity regularly carried on for profit. An employee would not be considered a taxable person with respect to activities engaged in as an employee.

b. Sales of property

Under the bill, the term "sale of property" would not be restricted to the sale of property for cash in the usual sense. For purposes of the VAT, a sale of property would include:

(1) the exchange of property for property [12] or services;

(2) the transfer of property to an employee as compensation (unless the transfer is a type for which no amount is includible in the income of the employee);

(3) a sale of property to a governmental entity; [13] and

(4) a sale of property by a governmental entity or by certain tax-exempt entities.[14]

The bill would define "property" to mean any tangible property. Thus, the sale of such intangible property as stocks, bonds, securities, franchise rights, patents, copyrights, and other intellectual property would not be subject to the VAT. This dichotomy in the treatment of tangible versus intangible property raises certain issues. For instance, certain assets possessing characteristics of both tangibility and intangibility (such as computer software) would be difficult to classify for purposes of taxation. Such classification issues often have arisen in the area of State sales and use and property taxation and in the area of the investment tax credit as it existed before the Tax Reform Act of 1986.[15]

In addition, since the sale of tangible property by a corporation would be subject to the VAT, while the sale of intangible property by an individual would not, a shareholder who wishes to dispose of his or her wholly-owned corporate business may sell his or her stock rather than have the corporation sell its assets and liquidate in order to avoid the VAT.[16] Alternatively, an individual may wish to dispose of an asset that would otherwise be subject to the VAT (such as real property). In order to avoid the VAT, the taxpayer could contribute the property to a newly formed corporation and sell the stock.

c. Performance of services

The performance of services in a commercial-type transaction would be subject to the VAT. The bill would provide several examples of includable items rather than an overall definition of services. Activities treated as the taxable performance of services would include (but would not be limited to) permitting the use of property, the granting of a right to the performance of services or to reimbursement (including the grant of warranties, insurance,[17] and similar items) and making of a covenant not to compete (or a similar agreement to refrain from doing something).

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[12] Such an exchange presumably would include a like-kind exchange of property which would be tax-free under section 1031 of the Code. Administrative and procedural issues arise as to how the VAT would be collected and reported on such a transaction without affecting its tax-free status under the income tax.

[13] Note, however, that the sale of property to a governmental entity will be zero rated for purposes of the VAT, as further discussed at pp. 20–21 of this pamphlet.

[14] Certain sales of property by a governmental entity or a tax-exempt organization would have a zero rating while other sales would be subject to the VAT at the full five percent rate. See pp. 20–22 of this pamphlet.

[15] *See*, for example, Robert W. McGee, *Software Taxation*, National Association of Accountants, 1984, chapters 1 and 3.

[16] Under the British VAT this is not a problem, as the U.K. Treasury has exercised its authority to rule that the transfer of a business as a going concern is not a transaction subject to tax. *See*, Alan Schenk, *Value Added Tax—A Model Statute and Commentary, A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation* (hereinafter "ABA Report"), 1989, p. 29.

Because property would be defined to include only tangible property, it is unclear whether the bill would treat the licensing of intangible property to be the taxable performance of a service. Other VAT systems would subject the licensing of intangibles to tax, either by providing a broad definition of taxable services or by specifically including the licensing of intangibles as a taxable service.[18]

d. Definition of business

A noncorporate person would be subject to the VAT only if that person sells or leases real property, imports property, or sells property or performs services in connection with a business. Business would be broadly defined to include a trade or activity regularly carried on for profit. Thus, it appears that activities that constitute a trade or business (under Code sec. 162) or that encompass expenses for the production of income (under Code sec. 212) would qualify as a business under the bill. However, an activity that is regularly carried on without a profit motive (for example, a hobby) would not be subject to the VAT. Other VAT systems often define business in greater detail or include all activities regularly carried on as taxable, irrespective of the profit motive.[19]

e. Treatment of employees

For purposes of the bill, an employee would not be treated as a taxable person with respect to activities engaged in as an employee. These services would be incorporated into the value of the goods or services sold by the employer to customers and would be subject to the VAT upon sale. Since services provided by nonemployees would be subject to the VAT, the distinction between an employee and an independent contractor would be significant. The bill would utilize the payroll tax definition of employee utilized in present law for the payroll tax.

An employer's services for an employee would not be treated as the performance of a taxable service under the bill unless the services are a type that are included in the gross income of the employee. Thus, fringe benefits provided to employees that are excluded from Federal taxable income also would be excluded from the VAT. Some have argued that all fringe benefits provided to employees should be subject to the VAT on the theory that if the employee had been paid in cash (rather than with the fringe benefit) and had used the cash to purchase the fringe benefit, a VAT would be collected on the subsequent purchase. The desire to adhere to such a theory must be weighed against the administrative difficulties in creating two separate tax regimes (VAT and income) for the same fringe benefit.

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[17] *See* pp. 25–28 for a discussion of the special rules relating to insurance.

[18] *See*, Duignan, James "Technical Features of the Value-Added Tax in Europe," prepared for the International Monetary Fund, Fiscal Affairs Department, 1970, at pp. 19–22.

[19] *See*, New Zealand Stat. 1985 No. 141, sec. 8(1) (New Zealand Goods and Services Tax Act) and sec. 4003 of the American Bar Association's Model VAT Statute, both of which would subject hobby transactions that are regularly carried on to the VAT.

f. Treatment of business gifts

The gift of business property or services would be a taxable transaction in the amount of the fair market value of the gift. The term "gift" would include property or services transferred in connection with business promotion activities. Thus, if a corporation donated inventory to a charitable organization and the inventory had a fair market value in excess of the corporation's cost, the donor corporation would be subject to a net VAT liability (after taking into account the VAT credit) on the amount of value the corporation had had added to the inventory. Other VAT systems either impose no tax when property or services are transferred at no cost or impose a tax based on the cost of the property or service.[20]

Imposing a VAT liability on the fair market value of promotional transfers raises issues concerning sales of goods or services at less than fair market value (i.e., "loss leaders"). If a taxable person sold a new product at a deeply discounted price in order to create a market for such a good, it is unclear whether the VAT liability, as imposed under the bill, would be based on the undiscounted, fair market value of the good or the discounted purchase price. If the undiscounted, fair market price controls, the determination of such an amount may be difficult and potentially subject to dispute between the taxable person and tax authorities. In addition, even if the fair market price could be determined at the time of the sale, the seller would be required to charge a customer a VAT based on the higher fair market value or make up the shortfall itself.

If, on the other hand, VAT liability were based on the discounted purchase price of the goods or services when sold, but were based on the fair market value of the goods or services when a gift, there would be a strong incentive to structure business gifts in the form of purchases for nominal amounts.

g. Personal use by owners

The bill would treat the personal use of business property or services by an owner of the business as a taxable transaction subject to the VAT at the fair market value of the property or services. Such treatment is consistent with the treatment prescribed by the bill for taxable fringe benefits provided to employees and business gifts and with the present law income tax rules regarding the constructive distribution of property or services to shareholders. However, it has been suggested that this rule, as drafted, could technically tax farmers and fishermen on the personal use of their own produce.[21]

2. Invoice requirement/credit mechanism

Under the bill, business purchasers would receive tax credits for VAT paid by domestic sellers of inputs or for VAT paid on imported inputs. Although tax would have to be paid by sellers on each transaction at every stage of production and distribution, credits would also be provided to all purchasers (except the final (nonbusiness) purchaser (the ultimate consumer)), so the net taxable amount at a particular stage of production or distribution represents the value added by that taxpayer at that stage of production or distribution. VAT credits prevent the imposition of multiple layers of tax with respect to the total final purchase price.[22]

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[20] *See*, sec. 10(9) of the New Zealand VAT Act, supra, and art. 11A(1)(b) European Economic Community's Sixth Council Directive of May 17, 1977, "On the Harmonization of the Laws of the Member States Relating to Turnover Taxes-Common System of Value Added Tax: Uniform Assessment," Official Journal No. L145.

[21] *See*, ABA Report, at p. 162.

The VAT credit would be used to reduce VAT liability. If VAT credits exceeded VAT liability, an amount equal to that excess is refunded to the taxpayer.

In order to receive a credit, a business purchaser would be required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. However, regulations could waive the invoice requirement where the amount of credit is *de minimis*, the taxpayer through no fault of his own does not posses a tax invoice, or the amount of credit can be reliably documented by sampling or some other method.

It is often argued that one advantage of the credit invoice method of collecting a VAT is that enforcement is enhanced because invoices are available for audit purposes.[23] In addition, the VAT possesses a degree of self-enforcement since the tendency by sellers to underreport sales and reduce taxes will be offset by the incentive of purchasers to report sales at their full price in order to receive full tax credits. However, these enforcement mechanisms are useful only if there is a credible threat of audits. Also, at the retail level, there is no incentive for the final consumer to counter the sellers' incentive not to report sales since the final consumer does not receive a VAT credit.[24]

Credits should only be available to businesses when purchases are used for business purposes. If final consumers receive credits, no net tax is paid. For example, an automobile used for nonbusiness purposes would entirely escape tax if credits were allowed on the purchase for nonbusiness purposes. The bill would disallow credits for property not used for business purposes. This may, however, lead to administrative complexity, in that whether something is subject to the VAT depends on the use to which the item is put, not just the identity of the purchaser. Thus, there may be significant avoidance of the VAT with respect to purchases of business property that is used for nonbusiness purposes. Similarly, credits should not be allowed for inputs allocable to nontaxable transactions. If property or services are used partly for nonbusiness purposes or partly for nontaxable transactions, the amount of VAT credit allowable would only be that amount allocable to taxable business transactions.

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[22] For an example of how this operates, see Example 2 in C.3., pp. 15-16.

[23] *See*, for example, Charles E. McLure, "Tax Restructuring Act of 1979: Time for an American Value-Added Tax?" *Public Policy*, Vol. 28, No. 3, p. 306.

[24] *See* U.S. General Accounting Office, *The Value-added Tax—What Else Should We Know About It?*, PAD-81-60, March 3, 1981, pp. 32-34.

3. Zero-rated items and exemptions from the VAT

a. In general

Exclusions from the VAT

Most VAT experts believe that the simplest and most efficient VAT would impose a uniform, flat rate of tax on a broad base of goods and services. However, economic, social, political, and administrative factors often dictate that certain goods and services are either excluded from the VAT or are subject to the VAT at a reduced rate. For example, a VAT that would impose a flat rate of tax on all consumption is considered by some to be regressive because consumption (as a percentage of income) falls as income rises. Therefore, in order to mitigate regressivity, almost all VAT systems adopted to date provide exclusionary relief for certain basic necessities such as food, clothing, shelter, or medicine. Certain enterprises (such as small businesses or farms) often are exempted from the VAT because both the compliance costs of the taxpayer and the administrative costs of the government are considered to outweigh the benefits of additional tax collections. Other goods or services often are eliminated from the VAT system because of the difficulty in accurately measuring the amount of value added (for example, financial services). Finally, exported goods generally are not subject to the VAT (this is generally accomplished by permitting the exporter to claim a credit for the VAT previously paid on the item being exported).

Goods, services, or enterprises may be taken out of a VAT system either by providing a zero rating or an exemption. There are significant differences in the two alternatives. If a sale is zero rated, the sale is still a taxable transaction, but the rate of tax is zero percent. Thus, sellers of zero-rated goods or services will not collect or remit any VAT on their sales. However, sellers of zero-rated goods or services may claim refunds for the VAT they paid with respect to purchased goods and services. Likewise, sellers that are exempt from VAT on their sales of goods or services will not collect any VAT on their sales. However, such sellers may not claim any refunds of the VAT they may have paid on their purchases.

Examples of zero rating and exemption

Whether a sale is zero rated or exempted from the VAT will have different effects upon the seller and the government, as shown in Examples 1–3 below.

Example 1. Assume a manufacturer purchases cotton from a supplier for $1000. The supplier has no purchases that are subject to the VAT. The manufacturer converts the cotton into clothing which is sold for $1200. The jurisdiction in question levies a VAT at a rate of 10 percent.

If the jurisdiction provides VAT relief for clothing but not cotton, either through exemption or through zero rating, the results would be as follows:

Production stage	Exemption	Zero rating
Supplier:		
Gross VAT	100	100
Credit	0	0
Net VAT	100	100
Manufacturer:		
Gross VAT	0	0
Credit	0	(100)
Net VAT	0	(100)
Total VAT collected	100	0

In the example above, if cotton rather than clothing were the item to which relief was granted, either an exemption or a zero rating would produce the same result, as follows.

Production stage	Exemption	Zero rating
Supplier:		
Gross VAT	0	0
Credit	0	0
Net VAT	0	0
Manufacturer:		
Gross VAT	120	120
Credit	0	0
Net VAT	120	120
Total VAT collected	120	120

The stage in production at which the VAT relief is granted may affect the amount of total taxes collected. A VAT system that zero rates sales at the final stage of production has the effect of refunding all VAT collected throughout the production of the item. A system that zero rates an intermediate step of production will result in the same amount of tax being collected as if no relief had been granted.

Example 2. Assume the same facts as in Example 1 above, except that the manufacturer sells the clothing to a retailer, who in turn sells the goods to consumers for $1500. The results of providing a zero rating at various stages of production are as follows.

Production stage	Zero Rating for—		
	No one	Manufacturer	Retailer
Supplier:			
Gross VAT	100	100	100
Credit	0	0	0
Net VAT	100	100	100
Manufacturer:			
Gross VAT	120	0	120
Credit	(100)	(100)	(100)
Net VAT	20	(100)	20
Retailer:			
Gross VAT	150	150	0
Credit	(120)	0	(120)
Net VAT	30	150	(120)
Total VAT collected	150	150	0

Example 3. If the relief granted in Example 2 were in the form of an exemption rather than a zero rating, the results would be as follows:

Production stage	Exemption for—		
	No one	Manufacturer	Retailer
Supplier:			
Gross VAT	100	100	100
Credit	0	0	0
Net VAT	100	100	100
Manufacturer:			
Gross VAT	120	0	120
Credit	(100)	0	(100)
Net VAT	20	0	20
Retailer:			
Gross VAT	150	150	0
Credit	(120)	0	0
Net VAT	30	150	0
Total VAT collected	150	250	120

In Example 3, the exempt manufacturer may be in a worse position than if no exemption were granted. Although the manufacturer pays no VAT on the sale, neither the manufacturer nor the retailer receive credit for the $100 of VAT paid by the supplier. Thus, the total amount of VAT paid through the production process is greater when the intermediate seller is exempt from the VAT than when the intermediate seller is taxable (even if it is zero rated). In addition, if an intermediate seller is exempt from the VAT, the total amount of VAT paid will be greater than (and bear no necessary relationship to) the theoretically correct amount of the VAT on an item.

Administrative issues

The form of the relief from the VAT (zero rating versus exemption) raises certain administrative issues. For instance, if the intent of the relief is to ease the administrative burden of a certain class of sellers, the exemption method may be preferable since it totally eliminates VAT bookkeeping requirements. Under a zero-rating system, the seller is still considered a VAT taxpayer and must maintain records in order to determine the amount of VAT credit for which it is eligible.

On the other hand, an exemption may increase the total VAT paid and cause administrative complications in some instances. The VAT credit generally is allowable only with respect to the VAT paid on the purchase of goods or services that are used for the production of taxable goods and services. If a taxpayer engages in both taxable and tax-exempt transactions, the amount of VAT paid on inputs must be allocated or apportioned between the taxable and tax-exempt activities in order to determine the amount of VAT credit allowable. Such an issue does not arise under a zero rating system. If a taxpayer engages in both fully taxable and zero-rated transactions, all his activities are considered to be taxable for purposes of the VAT credit and no allocations need be made.

Finally, with respect to either exempted or zero-rated activities, a clear definition of the transactions that qualify for the relief becomes critical for purposes of reducing the number of potential disputes between the taxpayer and the taxing authorities and between the taxpayer and its customers.

For these and other reasons, it generally is agreed among VAT experts that a VAT system that is applicable to a broad base of consumption is theoretically preferable to a system that provides a wide range of exclusions. It is also generally agreed that zero-rating is theoretically preferable to exemptions.

b. Exclusions provided by the bill

The bill would provide various exclusions from the VAT. Most of the explicit exclusions are in the form of zero ratings (discussed in detail below) as opposed to exemptions. Explicit exemptions would be provided for employee services to his employer,[25] and for *de minimis* activities.[26] However, the bill also would provide for implicit exemptions by narrowly defining taxable transactions. For instance, it appears that the sale of intangible property would not be subject to the VAT.

Food

The bill would provide that the retail sale of food and nonalcoholic beverages for human consumption (other than consumption on the premises) would be zero rated.

Most VAT systems in other countries provide some sort of relief for purchases of food, generally on the grounds of the regressivity of the VAT. Those who favor a tax on all consumption argue that an exclusion for food (as well as other items normally considered to be necessities of life) favors those with higher incomes who are better able to afford more expensive foodstuffs. They would propose other ways to combat any regressivity imposed by a broad-based VAT, including income tax relief or increased means-tested government assistance. In addition, those who favor a broad-based VAT argue that providing exclusions from the VAT may create artificial consumer demands for the excluded products or services.

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[25] As discussed in section III. C. 1. of this pamphlet, p. 11.

[26] As discussed in section III. C. 7. of this pamphlet, pp. 28–29.

Other VAT systems have addressed the regressivity issue with respect to food by providing different VAT rates for different types of food, with "luxury" items bearing a greater tax rate.[27] Such systems, however, impose the administrative burdens of identifying goods that are similar but are differently rated. This type of administrative burden may also exist in the VAT imposed by the bill. For instance, the bill would tax food prepared and consumed on the premises, while it would zero rate food prepared on the premises but consumed at home. This would require different tax treatment of identical items purchased at a facility that offers the purchaser the option of either eating on the premises or carrying food out (e.g., a fast food restaurant).

Housing

The bill would provide a zero rating for the sale and renting of residential real property used by the purchaser or tenant as a principal residence. A mobile or floating home would be treated as real property.

Zero ratings for housing would favor those who choose to spend a relatively large proportion of their income on housing and may provide an incentive to increase housing consumption relative to other goods. However, the taxation of housing is a troublesome area even for those who favor a tax on all consumption.[28] First, if housing were to be subject to the VAT, purchasers and tenants should be treated equally. The taxation of tenants is relatively easy—a VAT would be imposed on periodic rents.

The VAT treatment of purchasers may be more difficult. The tax point for purchases of goods generally would be the date of acquisition. In the case of home sales, imposing a large VAT liability at the point of purchase, however, may be viewed as burdensome and may discriminate between existing home owners and new purchasers. One solution to the differing treatment of owners and renters would be to base the VAT on the imputed fair rental value of owner-occupied housing. Such imputations historically have been difficult to implement and administer.

The bill does not define principal residence, but presumably the term would be given the same meaning as that used for Federal income tax purposes. Also not addressed in the bill is the situation of the purchase or rental of furnished housing. In such instances, an allocation must be made between amounts charged for the zero-rated item (housing) and the taxable item (furnishings).

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[27] For example, Italy imposes a 18-percent VAT on the purchase of pate and fancy chocolates, but only a 2-percent VAT on bread and pasta.

[28] *See*, the discussion in *Treasury Report for Fairness, Simplicity, and Economic Growth*, Treasury Department Report to the President (hereinafter "Treasury Report"), Vol. 3, 1984, p. 72.

Medical care

The bill would provide a zero rating for medical care. Medical care would be defined as the performance of any service and the retail sale of any property, the payment of which would eligible for an income tax deduction (ignoring the limits imposed by section 213(a)). Such costs would include health insurance premiums.

The analysis of whether or not to exclude medical care from the VAT is no different than the analysis required for any other good or service. A zero rating of medical care would encompass amounts spent for private as well as publicly supported care. It can be argued that the regressivity of imposing a VAT on medical care can be alleviated by increasing other means-tested health programs rather than by providing a zero rating.

Farmers and fishermen

Sales by farmers and fishermen (other than at retail) of their produce would be zero rated under the bill. Presumably, the retail sale of such items would qualify for the zero rating allowed for sales of food (to the extent they constitute food).

The 1984 Treasury Report [29] states that it is not feasible to treat farmers and their products the same as other segments of the economy. The report suggests that it may be appropriate to exempt farmers from the VAT since including the large number of small farmers in the VAT system would tend to increase administrative costs and burdens for both the Government and taxpayers. In addition, some sort of exclusion may be appropriate since a relatively large percentage of U.S. agricultural produce is shipped overseas and a VAT system designed consistently with the destination principle would zero rate exports.

Exempting rather than zero rating farmers would not allow farmers to claim a credit for the VAT incurred on farm inputs. Several solutions have been offered with respect to this issue. Farmers could be zero rated (as would be done under the bill) despite the increased administrative and compliance costs. Alternatively, farmers could be allowed to elect to be either zero rated or exempt. Such an election may discriminate in favor of large farmers who could bear the related compliance costs. Farmers could be exempted from the VAT but allowed an income tax credit for the VAT on their purchases. Such a solution would only be feasible if all farmers filed income tax returns and may merely shift the underlying complexities to the income tax system. One solution that is widely used in Europe would be to exempt farmers and allow the purchasers of farm products to presume that a certain percentage, specified by the government, of the purchase price of farm products is related to the VAT. The purchasers would be allowed a VAT credit with respect to the presumed VAT, thus attempting to compensate for the lack of VAT credit at the farm level. A final solution would be to exempt farmers and zero rate sales to farmers. Under such a proposal, farmers would not bear any compliance or purchase costs but would, however, be required to prove their status at the time of purchase.

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[29] Treasury Report, at p. 61.

Mass transit

The performance of mass transportation services in urbanized areas would be zero rated under the bill. The bill does not provide a definition of either mass transportation or urbanized area. Thus, for example, while bus or subway service within one city would likely qualify for the zero rating, it is unclear whether rail or air service between two cities in a densely populated area (e.g., within the Northeast corridor) would also qualify.

As in the case of medical care, the bill would not distinguish between mass transportation subsidized by the government and that provided by private enterprises. However, since most urban mass transportation is subsidized by a government in order to relieve problems caused by traffic congestion and pollution, it may be appropriate to exclude such services from the VAT. If such services were taxed, fares would rise by the amount of the tax and ridership may fall, thus requiring increased subsidizes. In addition, because of the relatively small dollar value of each purchase, there may be administrative benefits to excluding these services.

Exports

The bill would provide a zero rating for exports. This provision is consistent with the destination principle that holds that goods and services should be taxed in the jurisdiction of consumption rather than the jurisdiction of origin. Other VAT systems also zero rate exports so that they may enter international trade free of all domestic VAT burden.[30]

Interest

The bill would provide a zero rating for interest. The term "interest" is not defined by the bill but presumably would include the items and amounts considered to be interest for Federal income tax purposes. The taxation of financial products and transactions, including interest, generally presents difficult issues for a VAT system.[31]

Government activities

Under the bill, sales to government entities would be zero rated. The providing of property or services by a governmental entity in connection with the education of students would also be zero rated. In addition, sales of property or the performance of services by government entities would also be zero rated unless the sale involves a specific charge or fee.

The treatment of governmental entities involves issues of administration, competitiveness, and intergovernmental relations. Specifically, questions arise as to whether the tax base can be accurately measured and how the tax would be collected, whether the government entity is in competition with a private enterprise, and whether it is appropriate for the Federal Government to include a State or local government in its tax system.

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[30] For a more detailed discussion of the treatment of exports, see section III. C. 5. of this pamphlet, pp. 23-25.

[31] *See* section III. C. 6. of this pamphlet, pp. 25-28, for a discussion of the treatment of financial services.

Federal, State and local governments generally provide services to the public for free or at a reduced charge. If governmental entities were required to collect VAT on such services, valuation and collection issues would arise. On the other hand, certain government services are provided at a cost commensurate with their fair market value (e.g., some city-owned parking garages). In such cases, the governmental entity may be viewed as if in competition with a private enterprise that offers the same service. It may be appropriate to subject such a sale to the VAT. Finally, intergovernmental relationship issues arise if a State or local government is subject to a Federal VAT on its purchases of goods and services. Even if the relationship issues could be resolved, there may be administrative problems in having all governmental entities register for the VAT and file the appropriate returns.

The bill would attempt to resolve these issues by providing that a governmental entity would not be required to pay VAT on the goods and services it purchases or collect VAT for the performance of its services (with the exception of services for which a separate fee is charged). In this way, governmental entities would not be burdened by the VAT on their purchases and most governmental entities would not be required to collect VAT pursuant to the performance of their services. In essence, such entities would have the benefits similar to exemption without the related cost of having to pay VAT on their purchases. Those governmental entities that charge a separate fee for their services would be required to collect VAT, as are private enterprises that perform similar services. However, the governmental entities would not be required to pay VAT on their purchases. Issues could arise under the bill as to whether it is appropriate to subject to VAT the performance of traditional government services where a nominal fee is charged (e.g., automobile licenses).

Exempt organizations

Under the bill, taxable transactions engaged in by an entity described in section 501(c)(3) of the Code (i.e., entities organized and operated for religious, charitable, educational, etc. purposes) would be zero rated unless such transactions are part of an unrelated business. Section 501(c)(3) organizations would be allowed a credit for all the VAT they were paid. In addition, sales of property or the performance of services by any tax-exempt entity other than a section 501(c)(3) would be also zero rated unless the sale involves a specific charge or fee.

The analysis of the issues relating to the taxation of tax-exempt entities is similar to that of governmental entities. Specifically, the issue arises as to whether it is appropriate to subject to the VAT either the purchases or activities of entities that have been granted income tax relief. In addition, it may not be possible to value the services provided by such entities. Although it may not be appropriate to subject most tax-exempt entities to the VAT, activities through which such entities compete with taxable entities may appropriately be subject to the VAT.

The bill would treat charitable organizations in much the same way that governmental entities are to be treated. Specifically, section 501(c)(3) organizations would not be required to collect VAT on activities other than activities for which they would be taxable as unrelated business income. Unlike governmental entities, such entities would be subject to the VAT on their taxable purchases, but would be able to obtain a refund for the entire amount paid. Tax-exempt entities other than section 501(c)(3) entities would be subject to the VAT on their activities for which a separate charge had been made.

4. Treatment of real property

In general, the bill would tax the sale or lease of business or nonbusiness real property by applying the VAT rate to the amount paid by the purchaser or lessee.[32] A seller of real property would receive a VAT credit for the VAT paid on the purchasing, constructing, or improving of the property. A lessor of real property would receive a credit for the VAT paid on the purchasing, constructing, improving, or maintaining of the leased property.

The bill would provide an important exception to these general rules by providing preferential treatment for certain housing. Under the bill, the sale or lease of housing used as a primary residence would be taxed at a zero rate. Thus, none of the value added with respect to housing used as a primary residence would be subject to tax.[33]

The bill would treat sales of new nonbusiness real property differently from sales of existing nonbusiness real property. While new nonbusiness real property would be taxed on the full sales price, existing nonbusiness real property would be taxed only on the difference between the sales price and the adjusted basis of the property. However, under the bill, amounts incurred before the effective date of the VAT would not be included in basis. Therefore, existing nonbusiness real property not previously subject to the VAT would be taxed on the full sales price.

This special treatment accorded existing nonbusiness real property is not relevant if the rate of tax is zero. Because housing used as a primary residence is zero rated under the bill, no VAT is imposed with respect to both new and existing housing used as a primary residence. However, nonbusiness real property that is not used as a primary residence, such as second homes, would be taxed to the extent VAT was not paid on previous sales.

Under any VAT, the preferential treatment of certain items increases the costs of administration and compliance. The preferential treatment of principal residences in particular adds complexity to the administration of the VAT. Unlike the preferential treatment of food, it is necessary for sellers and lessors of housing to determine how the housing will be used (i.e., whether the buyer or lessee will use the property as a principal residence.) In addition, difficult administrative issues may arise if a portion of the purchase price is attributable to nonhousing components (for example, appliances and other amenities, or business use of the home) or if a portion of the rent is attributable to nonhousing services (for example, parking or other facilities). In such cases, the preferential treatment of principal residences may be available for consumer goods other than housing.

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[32] Instead of applying a VAT to the purchase price of an asset, the VAT could be applied each taxable period to the rental value of the housing provided during that period. This would theoretically provide the same tax treatment as up-front application of the VAT because the purchase price of a capital asset should equal the present value of the expected rental stream. However, the amount of rental value for each year is difficult to determine without actual rental payments.

[33] An alternative method of providing preferential treatment for housing would be to provide a VAT exemption for (rather than zero rating) the sale or lease of housing used as a primary residence. If housing used as a primary residence were exempt from the VAT, a seller or lessor would neither pay tax on their sales nor receive credits on their purchases. Consequently, the value added by those other than the seller or lessor would be subject to tax. As with other preferentially treated items, exemption of housing at the retail level provides substantially less tax benefit to the taxpayer than zero-rating.

The preferential treatment of principal residences may also reduce economic efficiency. The additional tax incentive for residential housing provided by the bill could encourage the purchase of residential housing beyond economically efficient levels. The tax treatment of housing in the bill does not, however, favor owner-occupied housing over rental housing, as does the current income tax.

5. Determination of the location of goods and services

The bill generally would define taxable transactions as sales of property in the United States, the performance of services in the United States, and the importation of property into the United States. Exports would be subject to tax at a zero rate.

A VAT can be designed on the origination principle, whereby goods and services are taxed where produced, regardless of where they are consumed, or on the destination principle, whereby goods and services are subject to tax where they are consumed, regardless of where they are produced. Virtually all VATs, including the VAT proposed in the bill, are based on the destination principle. In order to implement the destination principle, exports must be relieved of the domestic VAT and the domestic VAT must be imposed on imports. This treatment of exports and imports is referred to as the border tax adjustment.

The border tax adjustment of a destination principle VAT serves two purposes. By taxing imports and not exports, the border tax adjustment generally ensures that the tax base for the VAT is domestic consumption. In coordination with VAT systems in other countries, border tax adjustments also ensure that value added taxes do not distort international trade and leads to neither taxation in multiple jurisdictions nor exemption from VAT in any jurisdiction. For purposes of performing the border tax adjustment, it thus is necessary to determine the location of potentially taxable transactions. The rules for determining the location of a transaction for tax purposes are known as source rules.

The bill would provide for border tax adjustments by subjecting imports to tax at the standard 5-percent rate and subjecting exports to tax at a zero rate, thus permitting refunds for previously paid VAT on the exports. Under the bill, imported property would be sourced where delivery takes place, except that real property would be sourced where the real property is located.

Services are typically more difficult to source than tangible goods. The bill generally would source services according to where the services are performed. This rule, while administratively simpler than some other alternatives, violates the purest form of the destination principle. For example, a U.S. firm may contract for services performed abroad but for use in the United States. Such a transaction presumably would not be subject to tax under the bill. However, the destination principle argues that this transaction should be a taxable transaction. Since the seller of the services may have no other connection with the United States, it may be administratively infeasible either to collect the tax from the seller or to identify the purchase of the service as an import and levy the tax on the importer. Likewise, services performed in the United States for use abroad ought to be exempt from tax under a strict interpretation of the destination principle, but would be taxable under the bill.

The problem of some services provided abroad being exempted from domestic VAT may not be a serious problem. As long as the sales of the purchaser of the service is subject to VAT, no tax revenue will be foregone. Since the cost of services provided would be reflected in the final sales of the purchaser, and thereby subject to tax, the full amount of VAT would be collected regardless of whether the seller of the service paid the VAT. The full amount of VAT would be collected because there would be no offsetting credit for previous VAT paid on the services purchased. Only in the case of exempt purchasers would the tax on foreign-provided services be avoided.

Value added taxes in other countries differ somewhat in their sourcing of services. The Sixth Directive of the European Communities generally provides for sourcing the service in the country where the supplier is established.[34] Under the directive, however, certain services, such as patent licenses, advertising, financial operations and certain others are sourced in the country of the establishment of the purchaser. It is necessary, therefore, under the directive, to determine the location of the seller's or purchaser's establishment. To the extent that sourcing rules can be harmonized among taxing jurisdictions, the number of transactions subject to tax by multiple jurisdictions or no jurisdictions can be reduced or eliminated.

For services performed both inside and outside the United States, the bill would provide that the service would be sourced in the United States if 50 percent or more of such service is performed in the United States; otherwise, the service would be sourced outside the United States. Examples of services performed both inside and outside the United States include international transportation and communications services.

The Internal Revenue Code, for purposes of determining whether income is within or without the United States, generally allocates and apportions income and expense between U.S. and foreign source income, including gross income earned partly within and without the United States (sec. 863). Special rules apply for international transportation and communications income so that half of the income is sourced within the United States and half without.

Rules similar to these existing source rules in the Code could serve as an alternative to the source rules in the bill. The rule in the bill would eliminate the need to allocate and apportion sales of services based on the percentage of the service connected to different locations. Under the bill, transactions would either be subject to full tax or no tax depending on whether more or less than 50 percent of the service is provided in the United States. Because of the all-or-nothing nature of the source rule in the bill, significant pressure may be placed on the accurate determination of the percentage of service provided in the United States in those cases where the percentage may be near 50 percent. Presumably, for cases where the percentage provided in the United States is not near 50 percent, the rule in the bill would be administratively easier than an apportionment rule.

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[34] Sixth Council Directive of May 17, 1977, "On the Harmonization of the Laws of the Member States Relating to Turnover Taxes-Common System of Value Added Tax: Uniform Basis of Assessment," Official Journal No. L145, reprinted in 2 CCH Common Mkt. Rep., par. 3165 (1977).

6. Treatment of insurance and other financial services

a. Treatment of insurance and other financial services

Under the bill, the provision of insurance would be considered the performance of services, and, consequently, would be subject to the 5-percent VAT that generally applies to the sale of property or the performance of services in the United States. In the case of insurance, the amount subject to tax would equal the excess of (1) the portion of the premium attributable to insurance coverage over (2) the actuarial cost to the insurer of providing the insurance coverage.

The provision of financial services by banks, savings and loans associations, and other similar entities would also be considered the performance of services. The bill provides, however, that the rate of tax imposed with respect to interest would be zero (i.e., zero rated).

b. Issues relating to the application of a VAT to insurance and other financial services

In general

One of the most difficult issues that must be addressed in developing a VAT is the treatment of insurance and other financial services. It is generally believed that based on considerations of economic efficiency and equity, all services (including financial services) should be included in the base of any VAT and should be taxed at the rate that generally applies to ordinary goods and services. A VAT that exempts or zero rates insurance and other financial services would create an artificial incentive to purchase these services rather than other taxable goods or services, and, consequently, would distort consumer preferences and the efficient allocation of resources. In addition, because higher-income individuals generally purchase greater amounts of insurance and other financial services than lower-income individuals, the exemption or zero rating of these services would make a VAT more regressive.

Notwithstanding these considerations, nearly all countries that currently impose a VAT provide an exemption for insurance and the lending activities of financial institutions.[35] The principal argument for exempting or zero rating insurance and the lending activities of financial institutions is that it is difficult as a practical matter to determine what portion of the premiums received by insurers and what portion of the deposits received by banks and other similar financial institutions should be subject to tax. The principal service provided by insurers to policyholders is the pooling of risks of loss. The primary service provided by banks and other similar entities to depositors is intermediation (i.e., the pooling of money for the purpose of investing). The imposition of a VAT on the gross amount of premiums or deposits received would result in a tax that bears no relation to the value added by insurers and other financial institutions.

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[35] All countries that are members of the European Economic Community (EEC) provide a VAT exemption for the lending activities of banks and similar financial institutions and for insurance, reinsurance, and related services performed by insurance brokers and agents. Some countries that exclude insurance from the VAT impose a separate retail tax on insurance.

Determination of taxable amount in the case of insurance

In the simplest case, the value added by insurers may be measured by the excess of the premiums received over the claims paid. The premiums paid for most life insurance contracts, however, includes a savings element that does not represent value added by the insurer for insurance services. Under a consumption-type VAT, the savings element of insurance contracts should not be included in the VAT base.

The bill attempts to address this concern by including in the insurer's VAT base only the excess of (1) the portion of the premium attributable to insurance coverage over (2) the actuarial cost to the insurer of providing the insurance coverage. The bill, however, does not provide guidance on how to determine the portion of the premium attributable to insurance coverage or the actuarial cost to the insurer of providing the insurance coverage. For example, in the case of single premium whole life insurance, it is unclear under the bill what portion of the premium is attributable to insurance coverage because the single premium funds the cost of insurance for the life of the insured. With respect to the actuarial cost of providing insurance coverage, it is uncertain under the bill whether the cost is to be based on industry-wide actuarial data or the insurer's own experience, and, if the latter, how to determine the insurer's own experience.

In order to avoid these difficult questions, it has been suggested that an alternative system apply to insurance.[36] Under this system, insurers would be subject to VAT on the gross amount of premiums received. Upon the occurrence of a claim, the insurer would gross-up the amount of the claim by the VAT rate in effect at that time. The insurer would be permitted to claim an input credit for the amount of the gross-up.[37]

Under this system, an insurer would be taxed solely on the value of the risk-pooling service that it provides without resorting to estimates or industry averages to determine the portion of the premium attributable to insurance coverage or the actuarial cost of insurance. Nevertheless, such an approach may be criticized for not taxing the value of the financial intermediation services provided by insurers that issue life insurance with a savings element.

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[36] *See* Barham, Poddar, and Whalley, "The Tax Treatment of Insurance Under a Consumption Type, Destination Basis VAT," 40 *National Tax Journal* 171 (1987).

[37] The treatment of the policyholder under this system would vary depending on whether or not the policyholder was a business. In the case of a business policyholder, an input credit would be available for the VAT imposed on the premium payments. At the time of a claim, the amount of the gross-up would be considered VAT payable by the business. In the case of a non-business policyholder, no input credit would be available as premiums are paid and no VAT would be payable with respect to the amount of the gross-up.

In order to address this criticism, it has been suggested by some that insurers should be subject to a subtractive-method VAT or an additive-method VAT in lieu of the credit-method VAT.[38] If a subtractive or additive method of computing VAT liability was adopted with respect to insurance while the rest of the economy was subject to a credit method, an adjustment would be necessary to insure that business purchasers of insurance obtain a credit for the VAT paid by insurers.

Determination of taxable amount in the case of lending activities of financial institutions

In the case of lending activities,[39] the value added by banks and other similar financial institutions may be measured by the excess of interest received from borrowers over the interest payable to depositors, reduced by the cost of purchased inputs. In order to tax this value added, it has been suggested that financial institutions be taxed on interest received from borrowers and that depositors be taxed on the interest paid by the financial institutions. In the case of nonbusiness depositors who cannot claim an input credit for such tax, however, this approach would result in the imposition of tax on interest income, which may be contrary to the purpose of a VAT.

In order to avoid the imposition of VAT on interest paid to nonbusiness depositors, it has also been suggested that insurers and other similar financial institutions be taxed under an additive or subtractive method VAT. The principal criticism of an additive system is that it requires a determination of the profits of insurers and other financial institutions, and, historically, it has been difficult under an income tax system to accurately determine such profits. It may also be difficult under an additive-method VAT to make accurate border adjustments that would be in compliance with GATT. A subtractive-method VAT for insurers and other financial institutions would pose similar problems.

Additional issues

If it is determined that the provision of insurance and the lending activities of financial institutions should be included in a VAT, at least two additional issues must be addressed. First, because a destination-based VAT only taxes services provided in the United States, rules are necessary to determine where insurance and lending activities are provided. Most countries that impose a VAT on insurance treat insurance services as occurring where the risk is located. Consequently, if a U.S. person insures a foreign risk, no VAT would be imposed on the transaction. Conversely, if a foreign person insures a U.S. risk, the transaction would be subject to the U.S. VAT. This approach may create collection problems in the case of foreign insurers that have no other connection with the United States. Second, it must be determined how the VAT is to apply to insurance and lending transactions where premiums or deposits are made before the effective date of the VAT and claims are paid or withdrawals occur after the effective date. A similar issue arises if the tax rate changes after the effective date.

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[38] Under a subtractive-method VAT, the base to which the rate of tax applies would be determined for any taxable period by subtracting the total cost of inputs from total sales. Under an additive-method VAT, the base to which the rate of tax applies for any taxable period would be determined by adding together all the elements of value added including wages, rents, interest, and net profit. Under either a subtractive or additive-method VAT, the entire value added by insurers, including the value of financial intermediation services, should theoretically be included in the VAT base.

[39] The discussion contained in this section addresses lending activities of banks and other similar financial institutions because such activities pose the most difficult VAT issues. In the case of other goods or services provided by financial institutions, such as the rental of safe deposit boxes or the issuance of checks, a separate charge is generally imposed with respect to these goods or services. A VAT should apply to these goods and services under the general rules applicable to goods or services. Difficulties would arise, however, if a separate charge is not imposed or the charge does not reflect the full value of the good or service.

7. Administrative provisions

a. Liability for VAT and invoicing

Under the bill, liability for the VAT would be imposed on the seller of property or services. In addition to paying the VAT, the seller would be required to provide a tax invoice (setting forth the amount of VAT imposed on the sale, the name and identification number of the seller, the name of the purchaser, and certain other information) to the purchaser if the seller has reason to believe that the purchaser is a taxable person. The invoice would have to be furnished no later than 15 business days after the "tax point" for the transaction.

Generally, a purchaser would not be allowed to claim a VAT credit with respect to a transaction unless it has received a tax invoice in which it is named as purchaser.

b. Small business exemption

The bill would permit certain small businesses to elect not to be treated as a taxable person except with respect to imports and the sale or leasing of real property. If an election is made by a small business, no tax would be imposed on its sales and no credit would be permitted for VAT paid on its purchases.

A person could elect to be exempt under the bill if its taxable transactions do not exceed $20,000 for a calendar year and can reasonably be expected not to exceed $20,000 for the next calendar year. The election, however, would terminate on the first day of the second month following any calendar quarter in that next year if the following has occurred:

(1) aggregate taxable transactions for the calendar quarter exceed $7,000, in the case of the first calendar quarter; or

(2) aggregate taxable transactions for the first two calendar quarters exceed $12,000, in the case of the second calendar quarter; or

(3) aggregate taxable transactions for the first three calendar quarters exceed $17,000, in the case of the third calendar quarter.

An exception from the VAT for small businesses could substantially reduce compliance and administrative costs. An exception for small business could also, however, distort economic behavior. The existence and extent of the distortion would depend in part on the identities of the parties to a transaction. In certain transactions, exempt small businesses would be favored over businesses subject to the VAT. For example, if an individual needs to have $1,000 of plumbing work performed on a personal residence, the individual would prefer that the plumbing be performed by an exempt plumber (who would charge $1,000) rather than by a taxable plumber (who would charge $1,000 plus a $50 VAT).[40]

On the other hand, in other transactions businesses subject to the VAT would be favored over exempt small businesses. For example, assume that under the previous example a grocery store is in need of the plumbing and the work involves $800 of materials and $200 of labor. The exempt plumber would be required to pay $40 VAT on its purchase of materials, and, because it is exempt, would neither be permitted to claim a credit for the VAT it has paid nor issue a VAT invoice so that the grocery store could claim a credit for the VAT paid with respect to the materials. Thus, the exempt plumber would charge $1,040 for his work, and the grocery store would not be permitted to claim a credit for the $40 VAT. In addition, when the grocery store raises its prices to offset the $1,040 plumbing expense, it will charge VAT a second time on the $40 VAT the plumber previously paid.

The treatment of a plumber who is subject to the VAT would differ. A taxable plumber would also pay a $40 VAT with respect to the materials, but would charge $50 VAT on the entire transaction and claim a credit for the $40 VAT previously paid on the materials. The grocery store similarly would be allowed to claim a credit for the $50 VAT that it pays the plumber. The grocery store would pay the plumber $1,050 ($1,000 for the plumbing plus a $50 VAT), but, because the grocery store can claim the VAT it paid as a credit, the cost to the grocery store is in effect $1,000. The grocery store would charge its customers the theoretically correct VAT on the overhead attributable to these plumbing costs, and would not have to raise its prices by an additional increment to compensate for the "double VAT" that would be paid if the work were done by a VAT-exempt plumber. If the size of the small business exemption were increased, these distortive effects would be more pronounced.

In addition, because the bill would permit small businesses to elect to be treated as exempt from the VAT, small businesses would likely make the election based on the types of customers they generally deal with, which could increase the distortive effects as compared with a non-elective small business exemption.

c. Time for filing return and claiming credit

Under the bill, the taxable period for the VAT would generally be a calendar quarter. A taxpayer would, however, be allowed to elect a calendar month as the taxable period. A taxable person would be required to file a VAT return during the first month following the close of each taxable period. The return would reflect the VAT due on taxable transactions with a "tax point" in the period as well as the VAT credit allowed for the period. To the extent provided in regulations, monthly deposits of estimated VAT liability may be required.

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[40] This example assumes that both plumbers provide work of the same quality at the same price and that all of the economic burden of the VAT is borne by consumers.

The "tax point" describes when a taxable transaction occurs for purposes of the requirement that a taxable person furnish a tax invoice, as well as for purposes of determining in what taxable period the transaction must be reported. For a sale of property or services, the determination of the tax point would depend on whether the taxable person employs the cash method or an accrual method of accounting for Federal income tax purposes. In the case of a cash method taxpayer, the tax point would be the date that the taxable person receives payment for the goods or services. In the case of an accrual method taxpayer, the tax point would be the earlier of the date that the taxable person (1) should accrue income or loss with respect to the sale, or (2) receives payment for the goods or services. In the case of imports, the tax point would be the date that the imported property is entered (or withdrawn from warehouse) for consumption in the United States.

A VAT credit with respect to a purchase transaction would be allowed for a taxable period only if certain conditions were met. The taxable person would be required to have (1) paid or accrued (depending on its method of accounting for Federal income tax purposes) the VAT as part of the purchase price, and (2) received a tax invoice from the seller with respect to the transaction. The VAT credit would generally be allowed for the first taxable period in which both of these conditions were satisfied.

Many countries that impose a VAT use the calendar quarter as the taxable period.[41] Many countries also permit variations from the generally required schedule. Some permit (as does the bill) taxpayers to elect a calendar month as the taxable period. This election of a shorter taxable period may be of assistance to taxpayers that seek a more rapid refund of VAT that has been previously paid. Some countries also permit certain taxpayers to utilize a longer taxable period, such as a calendar year. Small businesses are often eligible for this longer taxable period in order to reduce the administrative burden that is imposed by a VAT.

A related issue is the time when deposits of VAT must be made. The bill would provide that regulations may require monthly deposits of VAT liability. Other deposit periods could also be considered. For example, under present law, corporations must deposit income taxes withheld from their employees and social security taxes as frequently as eight times a month (depending upon the size of the amounts to be deposited). A requirement that estimated VAT deposits be made with increasing frequency as the amount required to be deposited increases may help minimize collection problems for the Government. It would also be possible to require relatively infrequent deposits for some entities, such as small businesses. This can ease the administrative burden on these taxpayers. The Japanese VAT reportedly utilizes infrequent deposits by small businesses to encourage them to comply with the VAT (by giving them the use of the VAT they have collected for a period of time before it must be deposited). Decoupling the VAT deposit requirement from the return requirement may permit the utilization of longer periods for the return requirement without adversely affecting the flow of revenue from the VAT.

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[41] *See* ABA report, page 127.

d. Treatment of related businesses

Under the bill, a taxable person would be permitted to elect to treat itself and all related businesses as one taxable person for VAT purposes, to the extent provided in regulations. A related business would encompass any business under common control with the taxable person under the more than 50-percent control test described in section 52(b) of the Code. However, for purposes of determining qualification for the small business exemption, all businesses under common control would be treated as one business.

In addition, to the extent provided in regulations, a taxable person would be allowed to elect to treat any of its divisions as a separate taxable person.

e. Treasury notification and regulations

The bill would require a taxable person to notify the Internal Revenue Service if certain events occur. These reportable events would include a change in the form of a business or any other change that may affect VAT liability, VAT credit, or VAT administration with respect to the business.

The bill would also authorize the Secretary of the Treasury to issue regulations to implement the VAT.

f. Other administrative issues

There are several other administrative issues raised by the bill that might also be considered. The bill would require the Internal Revenue Service to administer the VAT (because the VAT is added to the Internal Revenue Code). One important issue is the number of additional personnel necessary to administer the VAT. The Treasury Department estimated in 1984 that once fully implemented it would cost $700 million per year to administer a VAT.[42] For comparative purposes, the total budget of the IRS for fiscal 1984 was approximately $3.3 billion. Another issue is whether the administrative and judicial procedures currently contained in the Internal Revenue Code should be extended to the VAT.

The bill would be effective for transactions occurring after December 31, 1989. It is unclear how much time between enactment and the effective date the IRS would need to prepare itself and educate taxpayers concerning the VAT. It is possible that the IRS could require substantial lead time before it could properly begin administration of a VAT.

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[42] *See* Treasury Report, p. 124.

IV. DESCRIPTION OF S. 659, S. 838, AND S. 849: ESTATE TAX INCLUSION RELATED TO VALUATION FREEZES

Present Law and Background

An estate freeze is a technique whereby an older generation seeks to cap the value of property at its present value and to pass any appreciation in the property to a younger generation. In doing so, the older generation retains income from, or control over, the property.

To effect a freeze, the older generation transfers an interest in the property that is likely to appreciate while retaining an interest in the property that is not likely to appreciate. Because the value of the transferred interest increases while the value of the retained interest remains relatively constant, the older generation has "frozen" the value of the property in the estate.

In one common form, the preferred stock freeze, a person owning preferred stock and common stock in a corporation transfers the common stock to another person. Since common stock generally appreciates in value more than preferred stock, the transferor has "frozen" the value of his holdings in the corporation. Other freezes utilize partnerships, trusts, options and joint ownership in property.

Estate freezes present three possibilities for avoiding transfer tax. First, because split interests with differing appreciation rights are inherently difficult to value, their creation can be used as an opportunity for undervaluing gifts. Second, such interests involve the creation of rights that, if not exercised in an arms-length manner, may be used as a means of subsequently transferring wealth free of transfer tax. For example, wealth may pass from a preferred shareholder to a common shareholder if the corporation fails to pay dividends on the preferred stock. Or, by exercising conversion, liquidation, put or voting rights in other than an arm's-length fashion (or by not exercising such rights before they lapse), the transferor may transfer part or all of the value of such rights. Third, the retention of a frozen interest may be used in order to retain enjoyment of the entire property. The transfer is, in reality, incomplete at the time of the initial transfer and, if the frozen interest is retained until death, the transfer is testamentary in nature.

In the Omnibus Budget Reconciliation Act of 1987, the Congress addressed the estate freeze transaction by including the value of the appreciating interest in the decedent's gross estate and crediting any gift tax previously paid (Code sec. 2036(c)). Such inclusion effectively treats the transfer as incomplete for transfer tax purposes until the freeze ceases. In the Technical and Miscellaneous Revenue Act of 1988, the Congress enacted safe harbors for the retention of debt and agreements to provide goods and services for fair market value.

Explanation of the Bills

The bills (S. 659, S. 838, and S. 849)[43] would repeal the estate tax inclusion with respect to valuation freezes retroactively from the date of its enactment (i.e., property transferred after December 17, 1987).

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[43] S. 659 (Senator Symms), S. 838 (Senator Heflin), and S. 849 (Senators Daschle, Heflin, Boren, and Symms).

V. DESCRIPTION OF S. 800: MORATORIUM ON CERTAIN STATE TAX LAWS

Present Law and Background

New York State adopted legislation in 1987, generally effective for tax years beginning in 1988 (N.Y. Tax Law Art. 22, sec. 601(e)), that changed the formula used by noncorporate nonresidents with New York-source income to compute their New York income taxes. The legislation requires such nonresidents to pay income tax on their New York-source income based on the tax bracket they would be in if all of their income (both New York and non-New York-source) were New York-source. Prior to the legislation, such nonresidents' tax brackets were determined solely by reference to their New York-source income. New Jersey State legislators recently introduced retaliatory legislation that would tax New Yorkers who earn income in New Jersey at New York State tax rates, which generally are higher than New Jersey tax rates.

Other States, including California, have similar methods of computing income taxes of nonresidents with in-State income.

Federal tax law generally does not govern the State income taxation of nonresidents.

Explanation of the Bill

Moratorium

S. 800, introduced by Senators Bradley, Lautenberg, Dodd and Lieberman on April 13, 1989, would temporarily suspend the effect of the New York law described above, as well as any subsequent similar New York legislation and any State legislation that is enacted in response to such New York legislation.

Study

The bill would establish an Interstate Taxation Commission to study all such legislation, including consideration of appropriate methods of determining the tax base, tax rates and allocation of income, deductions and credits in the taxation of interstate income, and whether equitable and effective taxation of such income would be best served by a Federal, regional or State formula. The Commission would be required to prepare and transmit a report on its study to the President and the Congress not later than 9 months after the date the members of the Commission are appointed.

The Commission would be comprised of the Attorney General of the United States (or his designee) and 3 members to be nominated by the President and confirmed by the Senate (1 each representing New York, New Jersey and Connecticut). The 3 nominees would be selected from a list of 6 individuals submitted to the President by each of the Governors of these States.

Effective Date

The moratorium period with respect to the State legislation described above would begin on January 1, 1988, and would end with any taxable year ending after the date which is one year after the date of the report to be prepared and transmitted by the Interstate Taxation Commission.

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PREPARED STATEMENT OF SENATOR DAVID BOREN

Mr. Chairman: I would like to thank you for scheduling this hearing on S. 849, a bill introduced by Senator Daschle which I have cosponsored with Senators Heflin and Symms. The intent of this legislation is to repeal section 2036(c) of the Internal Revenue Code. Rather than elaborating on the necessity of this legislation and my reasons for sponsoring it, let me touch briefly on a few points which will undoubtedly be focused on more fully by the witnesses and those submitting testimony today. It is clear to me a compelling case can be made for enactment of this legislation.

1. The current law is overly broad and unintelligible to even the most sophisticated counsel, let alone counsel representing many small family owned business or farms throughout the United States. Based on our recent experience with the supposed IRS clarifications of Section 89, I do not believe any forthcoming guidance from the IRS on Section 2036(c) will clarify the law.
2. The current law affects many ordinary, day-to-day business transactions that almost everyone would agree should not be covered.
3. The current law clearly discourages the continuation of family businesses by almost requiring sales to "outsiders."
4. The current law is a vast over-kill of what is essentially a valuation question. Surely a more sensible, targeted, anti-abuse provision could be developed.
5. This legislation should not lead to excessive revenue loss to the Treasury. The Conference Report on OBRA of 1987 indicated a three-year (1988–90) revenue gain, from what is essentially current law, of $109 million (the 1988 legislation supposedly liberalized the 1987 law). I hope this is not a situation where repeal now "costs" five times the revenue gain from the provision when originally enacted. Frankly, such a result would undermine the credibility of our Committee, the Congress, and the revenue estimating process itself.

In summary, I thank the Chairman again for this hearing. It is clear to me a more workable, sensible solution can be developed by Congress. I want to work with this Committee and other Senators to do so. In the meantime, however, Section 2036(c) must be repealed.

PREPARED STATEMENT OF SIJBREN CNOSSEN

Mr. Chairman, Members of this Committee, my name is Sijbren Cnossen. I am a Professor of Economics at Erasmus University in Rotterdam, The Netherlands. I have been an advisor on value-added taxes to the OECD, the World Bank, the International Monetary Fund, and various governments.

I appreciate the invitation and opportunity to participate in this hearing, and I hope that my remarks may contribute to your understanding of value-added taxes as well as to the general dialogue on taxation approaches to reducing the Federal budget deficit.

Last November, I had the privilege of discussing with Congressional Staff here in Washington the concept of a value-added tax as one step in reducing the structural budget deficit. Those roundtable discussions were published as a Special Report in *Tax Notes* on January 9, 1989. I am submitting a copy of that for today's hearing record along with an analysis which I have prepared for the Committee concerning the most desirable rate structure for a VAT.

The Federal budget deficit is the reason why the issue of a VAT in the U.S. arises. The Federal budget deficit itself acts like a hidden tax, converting savings which otherwise would be used for productive investment into fuel for government consumption and driving up interest rates. The U.S. has a particularly meager savings rate compared to other industrialized countries, and this exacerbates the economic impact of the Federal deficit. Although it may sound surprising, compared to other industrialized countries the U.S. is not a high tax country for example, in European countries total taxes as a percentage of CNP are 50 percent higher than in the U.S.—and among industrialized countries the U.S. is an exception in that it does not have a VAT.

Major points to bear in mind when considering a value-added tax are:

1. The value-added tax is the most "neutral" form of tax. If properly designed, it does not channel consumer choices or create economic distortions. It does not discriminate against certain products and in favor of others. It does not discriminate in favor of capital-intensive production processes and against labor-intensive production methods, or vice versa. Such tax neutrality is highly desirable in the increasingly interdependent and competitive world economic structure.
2. The VAT integrates the taxation of services with the taxation of goods. It permits the taxation of consumer goods while fully relieving capital equipment, intermediate goods, and raw materials from taxation, thus avoiding the cumulative effects of tax on tax. It permits comprehensive border tax adjustments, which means that imports can be taxed at the same rate as domestically produced goods, and that exports can be fully freed from tax in order to promote international competitiveness for American-made products.
3. A value-added tax is not inherently inflationary. It is not costly to collect. The multistage collection feature of a value-added tax does not cause greater working capital requirements for businesses.
4. In the U.S. context, a value-added tax does not seem to run the risk of becoming a Federal "money machine." The tangible economic dangers of a continuation of the budget deficit with its detrimental effects on saving and investment appear greater than the problems of creating a new tax instrument.
5. A value-added tax can be operated either independent of the retail sales taxes of the individual states or in conjunction with them.
6. The regressivity of a value-added tax can be eliminated by non-VAT measures, such as means-tested transfer payments and various entitlements, which offset the impact of a value-added tax on lower-income segments of the population.

In designing a value-added tax, it is essential to realize that economic neutrality and administrative feasibility are best served by a single, uniform tax rate which applies to virtually all goods and services. I would like to summarize the arguments for the critical concept of a uniform rate and against rate differentiation:

1. A value-added tax with a zero-rate or lower-than-standard rates is a relatively ineffective instrument for narrowing income differences. Means-tested transfer payments and various entitlements are much more effective in financially assisting lower-income groups than is tinkering with the structure of a value-added tax.
2. Given the amount of revenue which must be raised to address the Federal deficit, a lower, preferential rate for certain "essential commodities" would necessitate a higher standard rate on all other goods and services than if there were only a single, uniform rate for everything. Such a two-tiered rate system would create economic distortions.
3. A differentiated rate structure inevitably gives rise to problems of delineation and interpretation regarding the rate that should be applied to particular goods. These problems increase the cost of tax collection and compliance, as well as generate relentless political pressure to expand the preferential rate treatment to various product categories. There is evidence that small businesses bear more of the burden of the increase in compliance costs associated with a differentiated rate structure than do large enterprises.
4. Differences between income groups as far as their consumption patterns are concerned have largely disappeared. The characteristics of products bought by low-, middle-, and high-income consumers are similar, although their prices may differ. Moreover, depending on competitive considerations, different retailers may charge a wide range of prices for the same product or for substantially similar products. Thus, it is largely futile to design a VAT with discriminatorily

higher-than-standard Rates on so-called "luxury" product categories for the purpose of enhancing the VAT's progressivity.

5. Selective excise taxes and a properly designed system of user fees are more effective than a higher rate of value-added tax for such "big-ticket items" as expensive passenger cars, pleasure yachts, and private airplanes. Similar considerations apply to the taxation of tobacco products and alcoholic beverages.

In conclusion, I believe strongly that a value-added tax should be used only for the generation of revenue. Whereas other taxes, notably income tax, may be an important instrument in taxing people according to ability-to-pay, the sole purpose of a general consumption tax—a VAT—is raising revenue. In fulfilling that role, economic distortions should be minimized and administrative and compliance costs should be kept as low as possible. For a value-added tax, a single, uniform rate would make an important contribution to achieving these objectives.

It has been an exceptional privilege for me to share some thoughts on the value-added tax with you in the brief time available this morning, and I thank you for the opportunity.

WHAT KIND OF RATE STRUCTURE FOR A VALUE-ADDED TAX?

(By Sijbren Cnossen)

The most important issue in the design of a general consumption tax, such as a value-added tax (VAT), is the rate structure that should apply. Should all goods and services, regardless of the position they occupy in the "household baskets" of various income groups, be taxed at a single, uniform rate of tax? Or should a lower tax rate apply to necessities, i.e. commodities that are consumed disproportionately by the poor? Should a standard rate be supplemented by a higher rate on luxury products that are mainly consumed by the well-to-do? Obviously, a single, uniform rate is easier to administer and neutral as regards consumer preferences and producer choices. On the other hand, a lower-than-standard rate on essential products mitigates the VAT-burden on lower-income groups.

There are several compelling arguments in favor of a uniform VAT rate. Before examining them, the way in which the impact of a VAT is computed is discussed, as are the results of various impact studies in European countries.

IMPACT METHODOLOGY

1. It is generally assumed that a VAT is shifted forward into consumer prices. This is a plausible assumption, because as a rule the supply of goods and services is more elastic than their demand. Particularly in the longer run, producers can readily leave an industry, but consumers are less able to turn to alternative commodities. The more inelastic the demand relative to the supply, the greater the amount of the tax borne by the consumer relative to the producer.

2. The forward shifting of VAT means that its burden is distributed in relation to consumer expenditures on taxable commodities. Such expenditures can be ascertained from household budget surveys which show family expenditures on particular items of consumption during a period of time. Given the VAT rate, the total amount of tax included in the expenditures on each commodity or commodity group can then be calculated. Subsequently, all these amounts of tax can be summed and the total expressed as a percentage of family consumption expenditure or family income during the period under review. Observations at various points of the consumption expenditure or income distribution will then indicate how much tax different income groups pay. This is called the burden distribution pattern or impact of VAT.

3. By extension, changes in the ratio of VAT paid to expenditures made or income received by households at different points in the consumption or income distribution may be taken to indicate the nature of the impact of VAT. As one moves up the consumption or income distribution, a declining ratio implies that VAT is regressive, a rising ratio that it is progressive, and no change in the ratio means a proportional impact.

4. Although the precise impact of VAT is an empirical question, clearly a VAT levied through the retail stage, covering all goods and services and imposed at a uniform rate of tax, would, by definition, have a proportional impact when measured on the consumption base and a regressive impact when measured on the income base, because savings as a proportion of income rise when income rises. Of course, this picture alters if, instead of annual consumption or income, lifetime consumption or income is taken as the denominator. Even a uniform VAT might then be proportional with respect to income.

5. The proportional or regressive impact of VAT may be mitigated, i.e. be made slightly progressive or less regressive, by zero-rating or applying lower rates to essential goods and higher rates to luxury products. zero-rating means that the product to which the zero-rate applies is completely freed of tax, simply by refunding the tax invoiced by the supplier to the retailer selling that product to consumers. Thus, a zero-rate under VAT achieves the same objective as an exemption under a retail sales tax.

EXPERIENCE WITH DIFFERENTIATED RATES

In the industrial world, represented by the Organization for Economic Cooperation and Development (OECD), 20 out of 24 countries (the 12 members of the European Community (EC) and eight other countries) have adopted VAT as their main consumption tax. Thirteen of these 20 VAT-countries impose lower than standard rates on essentials and eight impose higher rates on luxuries. Most of those that do not impose higher rates use separate excise taxes to achieve the same purpose. In the original member states of the EC, rates were differentiated when VAT was introduced so that the impact pattern of the new tax would be as close as possible to that of the previously existing sales tax. The intention was to avoid complicating the discussion of VAT's merits as such with a debate about the proper distribution of the tax burden under VAT. Late converts to VAT, e.g., New Zealand and Japan, have tended to opt for a single, uniform rate (of course, with a zero-rate for exports).

In the EC, all member states except Denmark impose one or two reduced rates on items regarded as essential, such as food and other agricultural products, pharmaceutical goods and medicines, books and newspapers, and public transportation. Ireland, Italy, the United Kingdom, Spain and Portugal extend their reduced rates to a number of other items, including clothing and footwear, electricity, and household fuel. In fact, in Ireland, the United Kingdom, and Portugal, essential commodities are taxed at the zero-rate. Six EC member states impose higher-than-normal rates on items such as automobiles, audio-visual aids, jewelry and furs, perfumery and cosmetics, and various excisable goods. Although the coverage of the reduced rates comprises a sizable proportion of the tax base, ranging from 20 percent in Germany to 40 percent in the United Kingdom, the coverage of the increased rate is limited to some 5 to 7 percent of the tax base. Apart from Austria and Turkey, the non-EC countries that levy VAT generally do so at a uniform rate.

European experience with differentiated VAT rates indicates that the regressivity of VAT with respect to income can be moderated or eliminated. Impact studies, based on household budget surveys, show that in most countries the VAT burden is distributed proportionally over most of the income range. Usually some progressivity is noted for very low income groups and some regressivity for upper income ranges. Zero-rating, widely applied, is responsible for the slight progressivity of VAT in the United Kingdom. The same result, based on the rates prevailing in 1978, is reported for Italy, where rate differentiation makes the tax somewhat progressive. The variation in rates among commodities effects a rise of VAT from 4.9 percent of average family income among the lowest economic class to 7.4 percent among the highest class. A broadly proportional distribution of the VAT-burden is reported for West Germany, the Netherlands, and Belgium. The inclusion of services in the VAT base made the Dutch VAT less regressive than the turnover tax that it replaced. As might be expected, the Swedish VAT, which applies a single, uniform rate of tax without any differentiation for essential commodities, is regressive in its impact relative to a proportional income tax.

THE CASE AGAINST RATE DIFFERENTIATION

Despite the fairly widespread use of differentiated VAT-rates, particularly outside economically advanced countries, several convincing reasons can be advanced as to why rate differentiation should be avoided.

1. VAT is a relatively ineffective instrument for narrowing differences in pretax incomes. Thus, in Ireland, it was found that although the poor spend relatively more of their income on groceries than the rich, in absolute amounts the rich spend twice as much as the poor on groceries. Consequently, the zero-rating of groceries in Ireland gives twice as much tax relief to higher-income groups as to lower-income groups, obviously a very ineffective way of alleviating the plight of the poor. If, in Ireland, foodstuffs were taxed at the standard rate, this would raise an amount of revenue far in excess of what would be needed to offset the regressive impact of VAT.
2. In advanced industrial countries, such as the United States, in principle, much better tax measures are available to bring the overall tax burden distri-

bution in line with notions on ability-to-pay. Thus, income tax is much more sensitive than VAT to the economic position and the personal circumstances of individual taxpayers. Interestingly, a study on the VAT burden distribution in the United Kingdom notes that there would be little change in the tax system's overall progressivity if zero-rating was abolished and the revenue used to cut one point from the basic rate of income tax with the balance used to increase the tax threshold. Also, income transfer systems are much more effective than VAT in financially assisting lower income groups.

3. Differentiated rate structures distort consumer preferences (leading them to prefer one product over another) and producer choices (leading them to choose one production process over another). This is something VAT should not do in the absence of a compelling reason. If the tax differs from one category of goods to another, relative prices will change. These changes will in turn affect the quantities demanded, induce intersectoral movements of production factors, and result in changes in factor prices.

4. Given the amount of revenue to be raised, the application of a lower rate to essential commodities means that the standard rate must be higher than in the absence of the lower rate. This higher standard rate will magnify the distortions of consumer preferences and producer choices noted above, a serious defect if it is realized that as a rule the severity of tax distortions increases with the square of the tax rate that causes them. It has also been shown that high ad valorem rates have detrimental effects on product quality. These effects are more serious the higher the normal rate required to maintain revenue.

5. It makes little sense to apply a lower than standard rate to commodities, such as public transportation, whose prices are regulated or subsidized, since the levy of VAT in such cases is little more than a bookkeeping exercise. If the price of the publicly provided service is not to increase because of the tax, the better alternative is to apply the standard rate and increase the subsidy. This approach has the additional advantage of confronting policymakers with the full cost of public intervention.

6. A differentiated rate structure inevitably brings in its train delineation and interpretation problems regarding the rate that should be applied. Should expensive varieties of fish and meat be taxed at a higher rate than catfish and pork? Different rate classifications are very time-consuming for tax staff who must issue additional assessments (if the wrong rate has been applied), settle objections and deal with appeals. Even with careful design, anomalies cannot be avoided, as an examination of the VAT-rate schedules in various countries shows.

7. As the history of every rate-differentiated VAT testifies, it is difficult to keep the coverage of a reduced rate within its original bounds. A large number of reasons, often hard to counter, can usually be invoked for extending the preferential treatment to other goods and services. High-caliber staff must devote scarce time to answering queries from pressure groups, time that might be better used in checking compliance.

8. Differentiated rates involve a significant increase in administration and compliance costs, particularly for small businesses. It is not usually possible to keep separate accounts for differentially rated products, a circumstance that, in turn, aggravates the difficulty of monitoring compliance and blurs the distributive impact of lower rates, since small businesses tend to apply average markups, inclusive of tax. There is evidence that the increase in compliance costs is distributed regressively with respect to income: small businesses and marginally profitable businesses bear more of the burden than large firms.

9. If a lower tax rate applies to certain products, the amount of tax credits attached to higher-taxed purchases that are inputs for such products may exceed the gross tax chargeable on the lower-taxed sales. In other words, the tax office would have to honor a refund claim. Invariably, such claims arise if a zero-rate is used to free essential commodities completely of tax. This means that the tax administration is involved in an expensive collection and refund process that does not yield any net revenue. Basically, zero-rating (other than for exports where it is imperative) nullifies one of the important advantages of VAT, namely that the whole production/distribution process is involved in collecting the tax from the consumer. With a zero-rate, the tax office is not alerted if retailers claim a greater refund than the amount of tax shown on their purchase invoices.

The same arguments with respect to the efficacy of affecting the tax burden distribution, the administrative complexity of doing so, and the economic distortions caused by rate differentiation apply to higher than standard rates. However, there are also a few additional arguments in support of the view that such rates have no place in a properly designed VAT.

10. In practice, higher rates apply only to a small share of overall consumption; in other words, high rates do little to enhance the progressivity of VAT. This is not surprising, because tax-relevant differences in consumption patterns have largely disappeared. Higher-income groups often buy varieties of particular commodities that are more expensive than the varieties bought by lower-income groups, but rate structures based on prices rather than commodities are obviously not feasible. The rich also spend proportionately more than the poor do on holidays abroad or on education, but these expenditures either cannot be taxed or are excluded on merit grounds.

11. Expensive passenger cars, pleasure yachts, and private airplanes would seem to be products particularly suitable for increased VAT-rates. However, selective excises and a properly designed system of user charges, reflecting the costs of government-provided road, waterway and air services, can do a better job than a higher VAT-rate in identifying consumer preferences, reducing excessive use of public facilities, and promoting progressivity.

12. Countries with differentiated VAT-rates sometimes impose higher rates on tobacco products and alcoholic beverages. But if higher taxes on these goods are warranted, it makes more sense to increase the excise taxes, which are based on physical characteristics of the goods rather than on their value, and hence are more effective in restraining consumption and controlling quality.

13. It is difficult to enforce higher-than-standard rates on luxury items such as jewelry, cosmetics, perfumes, audio-visual equipment, and cameras. Individuals can easily bring these items in from abroad, in which case they might either fall under the personal exemption for import duty and VAT purposes or not be declared at all.

CONCLUSION

In the final analysis, of course, tax design or reform is not determined by academic concerns about economic distortions and administrative complexities; rather, it is the outcome of conflicting political views and interests. To keep the issues in a proper perspective, however, it is important to bear in mind that a value-added tax should be used only for generation of revenue. Whereas other taxes, notably the income tax, may be an important instrument in taxing the citizenry according to ability-to-pay, the sole purpose of a general consumption tax is raising revenue. In fulfilling that role, economic distortions should be minimized and administrative and compliance costs should be kept as low as possible. In the case of VAT, a single, uniform rate is essential to achieving these objectives.

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SPECIAL REPORT

TAX ANALYSTS

THE VALUE-ADDED TAX: QUESTIONS AND ANSWERS

by Sijbren Cnossen

Sijbren Cnossen is a Professor in the Economics Faculty at Erasmus University, Rotterdam, The Netherlands. He has written widely on the value-added tax (VAT) and advised international organizations and several countries on the design and implementation of a VAT.

This paper is based on his roundtable discussions with congressional staff members in Washington, D.C., on November 14 and 15, 1988. Professor Cnossen points out that, in the absence of an increase in the income taxes, the U.S. may have to introduce a VAT if the budget deficit is to be reduced to an acceptable level. He argues that a VAT is not inflationary or costly to collect and to comply with. Also, a VAT does not increase the working capital requirements of business enterprises. Although a VAT provides government with an easy tax handle, the money machine argument probably is overdone. In any case, a continuation of the present budget deficit would seem to be a greater evil than the introduction of a new tax. To be sure, a VAT is regressive, but Professor Cnossen thinks that there are various ways to offset its heavier impact on the poor. He believes strongly that the economic neutrality and administrative feasibility of a VAT are best served by a single, uniform rate of tax.

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Introduction

In the United States, the debate on the pros and cons of a value-added tax (VAT) has waxed and waned for 20 years. Initially, only academics were interested in a VAT, but, in recent years, various politicians and business groups also have shown a keen interest in its possibilities. Sweeping legislative proposals for introducing a VAT at the Federal level were made in 1980 by Rep. Al Ullman, then-Chairman of the House Committee on Ways and Means. In 1986, Sen. William V. Roth, Jr., R-Del., proposed a business transfer tax that is conceptually identical to a VAT. In the most recent Congress, Sen. Ernest F. Hollings, D-S.C., one of the sponsors of the Gramm-Rudman-Hollings Deficit Reduction Act, proposed a five-percent VAT.

Initially, only academics were interested in a VAT....

In the meantime, a VAT has been introduced throughout nearly the whole industrial world, as well as in several developing countries. Approximately 60 countries now have a VAT. A VAT has been implemented, or is about to be adopted, by the most important trading partners of the United States. All the member states of the European Community have a VAT, and Japan and Canada are on the verge of adopting it as well. The widespread introduction of a VAT probably is the most important tax structure event in the latter half of this century.

Proponents of a VAT, including the author, argue that a VAT is the most efficient, flexible, and economically neutral way to raise a given amount of revenue. Critics of a VAT in the U.S. and abroad argue that a VAT is inflationary, costly to collect and to comply with, secretive because its effects are hidden, onerous for businesses because their needs increase for working capital, a money machine because it enlarges the role and scope of government, in conflict with sound fiscal-Federal relationships because it encroaches upon the tax domain of the states, unfair because it is regressive, and so complex in design that it requires an inordinately long lead-in time. I consider these criticisms at worst myths and at best misleading. I shall address each one in turn, following some observations on the size and the dangers of the large Federal budget deficit.

Why More Revenue?

A VAT is foremost a revenue-raising measure. A broad-based, comprehensive VAT raises an amount of revenue equivalent to 0.5 percent of the gross domestic product (GDP) for each percentage point of the rate. Thus, a five-percent VAT would yield 2.5 percent of GDP in revenue, about $125 billion annually in the U.S. This assumes a limited number of exlusions and exemptions. Receipts from a VAT would be halved if most foods, housing, and medicines were excluded from the base.

The primary reason why so much revenue is needed is to reduce the Federal budget deficit to manageable proportions. According to the Congressional Budget Office, the deficit for fiscal year 1988 was $155 billion, or 3.2 percent of GDP; it is expected to decline to $120 billion in 1993. These amounts are *net* of the large Social Security surpluses that are being generated in anticipation of the formidable increase in benefits payable to the baby boom generation that will retire early in the next century. If these surpluses are taken into account, as they should be, the true deficit in 1993 will be $234 billion. In addition, some $50 billion is needed to halt the depletion of the reserves accumulated under the Medicare program.

If . . . [trust fund] surpluses are taken into account, as they should be, the true deficit in 1993 will be $234 billion.

What Is So Bad About the Deficit?

The budget deficit is not temporary, but structural; that is, it stretches into the future indefinitely. A high budget deficit is detrimental to national savings and economic growth. It pushes up interest rates, converts national savings into consumption rather than investment, thereby imperiling labor productivity and, hence, the scope for wage increases and, in short, economic growth. Much of the deficit is foreign-financed. In 1985, the U.S. turned from a creditor nation into a debtor nation, a status more appropriate for a developing country. Presumably, a situation in which foreigners tell a country what to do, because they own it, holds little attraction.

How Can the Deficit be Reduced?

The deficit can be reduced by cutting expenditures, by raising revenues, or, more likely, by some combination of these two measures. With heroic efforts, I assume that it would be possible to reduce expenditures by, say, $50 billion. It also might be possible to increase the excises on drinking, smoking, and driving. The "sin" taxes on drinking have not been raised since the 1950s. Simply adjusting them for inflation would yield $20 billion. Furthermore, imposing, say, a 25 cent tax on gasoline would yield $25 billion. But on the whole, it is difficult to imagine that agreement could be reached on excise measures yielding more than about $25 billion in all.

An increase in personal and corporate income rates (technically, the easiest and quickest "fix") no doubt would reopen discussions concerning the most appropriate treatment of capital gains (including the application of inflation adjustment schemes and special rates) and the need for investment incentives to offset the increase in the user cost of capital. Increasing income tax rates also might imply a breach of the implicit legislative promise that income tax rates would not be tinkered with for some time following passage of the 1986 base-broadening tax reform act. Last, but not least, income taxes distort the efficient allocation of resources by affecting economic choices: between debt and equity, between the corporate and the noncorporate form of doing business, between capital-intensive and labor-intensive production technology, and between present and future consumption (saving). The well documented welfare costs of these distortions increase exponentially with the income tax rates.

What is a VAT?

This leaves a broad-based consumption tax as the only alternative for new revenue measures if the budget deficit is to be brought down to an acceptable level. There are three kinds of consumption tax that deserve consideration: (1) a value-added tax of the type levied in the member states of the European Community; (2) a retail sales tax like that now operated in 45 states and the District of Columbia; and (3) a business transfer tax as proposed by Sen. Roth.

I shall concentrate mainly on the VAT. Conceptually, a VAT is a retail sales tax (RST), with which the U.S. is familiar. Given the same base and rate, a VAT has exactly the same economic effects, the same burden distribution, and yields the same amount of revenue, but instead of collecting the full tax from the retailer, a VAT spreads the collection of the tax throughout the entire production/distribution process. The full tax is collected by the retailer from the consumer. Of the full tax, the retailer remits to the Treasury that portion of the tax which equals the tax rate times the retailer's own value-added. He pays the rest of the tax to the wholesaler. In turn, the wholesaler remits an amount equal to the tax rate times its value-added to the Treasury, and so on.

The multistage collection technique of a VAT is achieved by permitting registered firms a credit for the tax paid on purchases of producer goods (raw materials and intermediate goods, as well as capital goods) against the tax payable on sales. In other words, the tax is limited to the "value-added" at each stage, which is simply defined as the difference between the value of sales and the value of purchases, both exclusive of tax. Because the tax must be stated on invoices (in order to provide documentary evidence for the credit claimed by registered buyers), the tax credit technique also is referred to as the invoice method. Basically, a VAT may be considered to be a retail sales tax that uses the tax credit technique instead of the suspension rule (through the use of exemption certificates) to eliminate cumulative effects.

It is difficult to imagine that agreement could be reached on excise measures yielding more than about $25 billion in all.

What is the Difference Between a VAT and a RST?

If a VAT is identical to a RST, why not collect the full tax at the retail stage, i.e., impose a RST? There are four reasons why a VAT is the preferred choice. These are: the potential coverage of the tax; the ability to distinguish producer goods from consumer goods; the ability to effect correct border tax adjustments; and the administrative feasibility of the tax.

First, nearly all RSTs have great difficulty in taxing services that are rendered primarily by small business establishments. Not taxing services means that services are favored over goods. This distorts economic choices, of both consumer and producer, and unnecessarily accentuates the regressive impact of the tax, because the demand for services generally is more income-elastic than is the demand for goods. In industrial countries, services comprise up to 50 percent of the national product: this is simply too large a portion of economic activity to be ignored by a broad-based consumption tax.

Second, RSTs have difficulties distinguishing between producer goods and consumer goods. How can a registered firm know that a shovel is not used for (taxable) gardening purposes rather than as an (exempt) input for farm work? Who knows whether sugar is used to sweeten tea (taxable) or as an (exempt) ingredient for (taxable) bakery products? A VAT has no difficulty on this score, because the seller is simply told to always charge tax, leaving it to the purchaser to obtain a tax credit if he is also a registered taxpayer.

Third, as a result of the inability of RSTs to distinguish effectively between producer and consumer goods, many producer goods are taxed. This means that the tax enters into the cost of exports with detrimental effects on international competitiveness. Similarly, since the prices of domestic goods incorporate an element of tax on capital goods, while goods imported from countries with a VAT do not, the former are artificially discriminated against.

Fourth, a VAT is a more robust form of consumption tax. It disperses the collection process over the whole of industry and commerce, it transfers part of the burden of proof with respect to the tax liability of taxpayers (who must prove that they are entitled to the tax credit on purchases), and it places a higher price on dishonesty than does a RST, because every invoice also is an agreement with respect to the tax liability.

Is a VAT Inflationary?

It is often alleged that a VAT is inflationary, that it would set in motion a spiral in which the tax, prices, and that wages would feed on each other. However, there is no evidence that this has happened in European countries, provided that a VAT is not introduced when the economy is overheated. Given a consumption base of about $3 trillion in the U.S., a $100 billion VAT probably would be accompanied by a price increase of some three percent if its introduction were accommodated by the monetary authorities, as is ordinarily done. Without wage hikes, disposable incomes would be reduced correspondingly. It should be noted, however, that the same effect would occur if an equal-yield increase in income taxes were enacted. Moreover, narrowing the budget deficit probably would dampen inflationary expectations and result in lower interest rates, which in turn would mean lower business costs. To eliminate the second-round inflationary impact of a VAT, if any, the tax might be eliminated from the consumer price index, which is often the basis for conducting wage negotiations.

Is a VAT Costly to Collect and to Comply With?

No broad-based tax is as easy to collect and to comply with as is a VAT. The 1984 U.S. Treasury report, *Tax Reform for Fairness, Simplicity and Economic Growth*, estimated that a VAT implementation would require 20,000 additional IRS staff members and that it would cost $750 million annually to run the tax program. In relative terms, these costs are less than one percent of the potential revenue yield of a broad-based VAT. This is well within the range found in European countries. These costs should be compared to the costs of the distortions, referred to above, emanating from the present large budget deficit and from alternative measures, such as a three-percent increase in the income tax rates, which would be required to provide the same amount of revenue. I have no doubt that the distortion costs are higher.

European experience shows that a VAT is easy to comply with. In its simplest form, complying with a VAT requires only two spindles: one on which sales invoices are pinned and another one for purchase invoices. Accounting for a VAT, then, simply involves adding the tax shown on all the sales invoices pinned on spindle A, deducting all the tax shown on purchase invoices pinned on spindle B, and remitting the difference to the Treasury. In practice, some minor year-end adjustments are necessary, as well as some accounting for goods for which the tax credit is denied. Basically, the spindle model stands. Interestingly, the ratio of VAT lawyers to income tax lawyers in European countries probably is fewer than one to 25, some indication of how easy a VAT is to comply with.

Is a VAT a Hidden Tax?

Another fallacy is that a VAT is a hidden tax, because it would be concealed in prices. This simply is not true. Actually, a VAT must be shown separately on invoices so that the purchaser can claim the tax credit. Some countries do not require or forbid this practice with respect to retail sales, but there is no reason why a VAT should not be shown on invoices for consumer purchases. This is currently the case with respect to most RSTs. In any case, a VAT is less of a hidden tax then, say, the income tax collected through wage withholding.

Does a VAT Impose an Extra Cost on Business?

Some people believe that pre-retail firms advance the tax under a VAT and, hence, that their working capital requirements are greater than under a RST. In other words, it is alleged that, since a VAT is partly collected at early stages, it imposes an extra burden on business in the form of an interest charge that could be avoided if the government would tax only the final stage, that is, impose a RST. This argument, however, is faulty, for the simple reason that the purchaser's right to a tax credit (and refund) logically arises at the same time at which the supplier must account for the tax. This is done by making the invoice date (in turn closely linked to the delivery date) the date on which the liability for tax arises (and, of course, the invoice date is the same for supplier and purchaser).

A VAT is less of a hidden tax than, say, the income tax collected through wage withholding.

It is a misunderstanding, therefore, to believe that the multistage collection feature of a VAT requires greater capital outlays than the single-stage collection characteristic of a RST, provided that (i) tax reporting and payment obligations, credit, and refund arrangements are synchronized with commercial payment conditions, and (ii) bad debts do not arise. Under a VAT, as under a RST, taxable firms will not even bear the cost of interest in financing carrying charges, e.g., on inventory accumulation or capital equipment purchases. Under a RST such goods are exempted; under a VAT the tax invoiced with respect to the same items will be refunded if the tax paid on purchases exceeds the tax payable on sales. This conclusion remains true even if production, sales, or net inventories rise or decline.

Is a VAT a Money Machine?

It is difficult to give a clear answer to the question whether a VAT hands government a tax instrument through which it can enlarge its role and scope. Of course, since a VAT is a very neutral and efficient tax, it is easy to collect and fairly difficult to evade. Absent potential distortions, there is no "natural" brake on increases in the tax rate, say, up to 20 percent. There is some truth in the money machine argument, but much less in a tax-conscious United States than in European countries where people are used to high levels of taxation. It also may be pointed out that the income tax would not have become the enormously productive mass tax it is if wage withholding had not been introduced. Neither would it have been possible to raise the revenue for Social Security without the pervasive use of employers' payroll taxes. Administratively, these mechanisms are akin to the multistage collection feature of a VAT. I am inclined to agree with Charles McLure, whose bottom line is that a continuation of the large budget deficit is a greater evil than the introduction of a VAT intended to remedy the shortfall in revenue.

Does a VAT Encroach Upon the Tax Base of the States?

Whether a VAT encroaches upon the tax domain of the states and localities is largely a political question. I have no particular expertise in this field. To be sure, theory informs us that sales taxes typically are suited for imposition by subordinate units of government, while income taxes should be levied by the Federal government, or, if collected at the state level, there should be an overarching Federal income tax to offset the differences in state income taxes. Since U.S. states have fairly widely invaded the income tax field, there seems to be an argument that the Federal government should not feel unduly apprehensive about claiming a share of the consumption tax pie. In some countries (Switzerland, for instance), income taxes are levied at the local level, but the sales tax is fully administered by the federal government.

States could be encouraged to piggyback the national VAT. . . .

Federal introduction of a VAT would broaden considerably the consumption tax base through the inclusion of services. A VAT also would make it possible to effectively tax mail order sales, which have been more or less outside the reach of state sales tax administrations since the *National Bellas Hess* case was decided by the Supreme Court in 1967. States could be encouraged to piggyback the national VAT (at reduced rates because services are covered) or, alternatively, a revenue sharing pool could be established.

Is a VAT Regressive?

A VAT is regressive, that is, since consumption as a share of income falls as income rises, a VAT levied at a uniform rate falls more heavily on the poor than on the rich. This is only true if the denominator is income, not if it is consumption; then, the impact would be proportional. A VAT's burden also would be largely proportional if the denominator were lifetime income rather than annual income. This is so because many income recipients are only temporarily in lower-income scales. A judgment on the impact of a VAT also would depend on the alternative revenue measures that would have to be taken. Income tax increases easily can be designed to be progressive, but excises cannot.

Fortunately, there are a number of ways to redress the regressive impact of a VAT. As Henry Aaron has pointed out, by increasing the VAT rate by one-fifth of one percentage point, it would be possible to raise benefits under the food stamp program, AFDC payments, and other means-tested programs. Another alternative would be to increase the earned income tax credit. Small adjustments to Social Security benefits also might be feasible. Canada has an interesting system for eliminating the sales tax burden on lower-income groups: sales tax payments of adults and children are averaged and paid out in an annual lump-sum to those below the poverty line. All in all, adjustments for sales tax regressivity would not cost more than, say, $5 billion, or less than one-fifth of a percentage point of tax. A much more imaginative approach would be to raise the VAT rate to eight to 10 percent and to use the extra revenues to reduce the payroll taxes that are highly regressive, distortionary, and which cannot be rebated on exports.

There are a number of ways to redress the regressive impact of a VAT.

I have not mentioned rate graduation as a possibility for mitigating the regressivity of a VAT. Admittedly, this is the route most European countries have taken. In fact, 13 out of 18 OECD member countries with a VAT have one or more lower rates on essential goods, such as foodstuffs, medicines, fuel, public transportation, and some other items. Ireland, the United Kingdom, and Portugal even zero-rate these goods. When introducing a VAT, European countries were concerned with staying as close as possible to the tax burden distribution of the previous turnover tax, so as not to jeopardize the acceptance of a completely novel tax. The U.S. is in the enviable position that it can learn from the mistakes made elsewhere and, like New Zealand, it can opt for a broad-based, single-rate VAT with regressivity adjustments elsewhere in the tax and income transfer system.

The arguments against differentiated rates are manifold. Rate graduation is a very blunt and expensive instrument to mitigate regressivity. In absolute amounts, the rich benefit more than the poor. As the European experience testifies, delineation problems abound: is caviar an essential foodstuff? Lower than standard rates complicate the task of traders who must account for the tax under different rates. Such rates also make enforcement and audit more problematic. Moreover, introducing a lower rate on products regarded as essential implies that the rate on nonessential goods and services must be increased to raise the same amount of revenue as a uniform rate would yield.

Similarly, increased rates make little sense. To the extent that they cover drinking, smoking, or driving, increases in the relating excises or user charges make more sense. Higher than standard rates also are difficult to enforce with respect to small, high-value items that easily can be smuggled in from abroad. The case for a single rate is even stronger if the general rate is kept fairly low, say, between five and 10 percent.

What is the Lead-in Time of a VAT?

The conventional wisdom is that it requires 18 to 24 months to make a VAT fully operational. Given the extensive experience with a VAT in other countries (from which the U.S. can learn), the number of U.S. scholars and professional people who already have a good working knowledge of a VAT, and the availability of a highly proficient tax staff in the IRS (a VAT has much in common with a business income tax), I believe that with a concerted effort, the lead-in time can be reduced by some six months. Of course, the best approach to expedite the introduction of a VAT is to start right away with molding a political consensus on the best way to reduce the budget deficit and by establishing VAT working parties within the body politic, the business community, and the IRS. I understand that a comprehensive finance bill at best cannot be introduced much before the end of 1989. This means that a VAT, if adopted, cannot be operational before the middle of 1991. In the meantime, a dent could be made in the budget deficit by selective, and possibly temporary, increases in the main excises.

A VAT, if adopted, cannot be operational before the middle of 1991.

Who Would Support a VAT?

Support for a VAT might come from some unexpected quarters—from liberals as well as conservatives, from politicians as well as business leaders, and from tax economists as well as tax administrators. Presumably, liberals would support a VAT because they worry about spending cuts in social programs and about the use of Social Security savings for government consumption. Conservatives fear the cuts that may have to be made in defense expenditures if the budget deficit is not cured through a tax increase. Business leaders are concerned about the low rate of saving, the high interest rates, and potential inflation dangers. Many economists favor the continuation of low income tax rates, and more generally, a move to heavier reliance on consumption taxes. Presumably, tax administrators would welcome an additional tax because there would be greater opportunities for their own job promotion! So, it might be possible to forge an "unholy alliance" for a VAT comprised of interest groups across the whole political spectrum.

Conclusion

I would like to conclude this discussion with a very brief resume of the main points:

- the Federal budget deficit is too large to be ignored;
- excise tax increases would bring in too little revenue;
- increases in income taxes seem politically unpalatable and would be economically inadvisable;
- therefore, the only way to remedy the budget deficit is to introduce a national consumption tax in the form of a value-added tax;
- a VAT has a number of commendable characteristics: it is a much more robust form of consumption tax than a RST, integrates the taxation of services with goods, distinguishes effectively between producer goods and consumer goods, and effects border tax adjustments better than RSTs;
- a VAT is not inherently inflationary and is not costly to collect; to make the tax more obvious, it should be quoted separately with respect to consumer purchases;
- the multistage collection feature of a VAT does not imply greater working capital requirements for business firms;
- in the U.S. context, a VAT does not seem much of a money machine; in any case, the dangers of a continuation of the budget deficit seem to loom larger than the creation of a new tax instrument;
- a VAT can be operated jointly with the states; and
- a VAT is regressive, but there are various ways to offset the heavier impact on the poor.

The Federal budget deficit is too large to be ignored....

Finally, the most important point to bear in mind in designing a VAT is that economic neutrality and administrative feasibility are best served by a single, uniform rate of tax.

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PREPARED STATEMENT OF RICHARD L. DEES

Good morning Senators. I am Richard L. Dees, a partner in the Chicago Estate Planning Department of McDermott, Will & Emery, a national law firm. I am now active in, and have held leadership positions in, the American Bar Association Section of Taxation, the Illinois State Bar Association Federal Taxation Council, the Chicago Bar Association Agriculture Committee and the American Agricultural Law Association. Today, however, I have been invited to express my personal views on Senate Bills 659, 838 and 849 repealing retroactively Section 2036(c). A simple example will show how Section 2036(c) attacks "freezes" and why it should be repealed.

Child is graduated with a Ph.D. in English. Parent loans Child a typewriter, perhaps one that has been in the family for years. Child writes the "Great American Novel" on the typewriter. The book rights will bring $1 million a year in royalties. Parent dies and IRS claims Child owes 55% estate tax on top of the income tax Child pays on the royalties.

This example satisfies the requirements of Section 2036(c) for a "freeze" transaction. First, the writing of Novel is for gain and, therefore, an "enterprise." Second, Parent "retained the right" to the return of the typewriter. Third, this retained right had little appreciation potential when compared to the Child's interest in the enterprise ("disproportionate appreciation"). Finally, the lending of the typewriter was a "transfer" of the right to use it in the enterprise. In fact, in this example all of the capital of the enterprise was attributable to Parent. Thus, under Section 2036(c) the entire value of the book rights could be subject to tax in Parent's estate. The child's efforts in the enterprise are disregarded.

While this is admittedly an extreme application of Section 2036(c), it is not that much different than a real life example of its application to family businesses. A partner of mine consulted recently with the owner of a bowling alley in a small midwestern city outside Chicago. The owner was 70 and ready to reduce his 10–14 hour days. His son was 35 and already working in the business. Father wants to shift the future appreciation in the business to the son so that he will have the incentive to work the hours necessary for the business to succeed. Father wants a secure income from his investment in the business and to retain control until he is sure that his son will succeed. A sale of the business is not practical as the family's entire wealth is invested in the bowling alley. While the bowling alley is worth only about $3 million, estate taxes could take more than $1 million of this value thereby destroying the business.

Prior to the 1987 enactment of Section 2036(c), my partner's recommendation would have been a preferred stock freeze. The father would have received preferred stock paying a market dividend rate. The stock would have voting control in order to ensure the payment of the dividend and to ensure the continued success of the business. After father's death, the preferred stock would be subject to estate tax at the full value of the business at the time the "freeze" occurred. The son, on the other hand, would have received common stock. He could not have received a dividend until father's preferred dividend was paid. He would bear the risk if the business failed and reap the benefits if the business prospered.

This type of family business succession ought to be encouraged, but instead is prohibited by Section 2036(c). Parents have capital and experience, while children have ideas and energy. The false premise of Section 2036(c) is that ideas and energy ought to be disregarded. As long as a parent is adequately compensated for the services provided and receives a fair return on capital invested in the business, appreciation on the gifted stock ought to shift to the child. It is not fair for Section 2036(c) to require the child also to pay an estate tax on any increase in the value of the business. Gifts of non-family business interests carry a right to future appreciation. A wealthy individual who can give his children $1 million dollars in cash, for example, never has any part of the appreciation from the cash included in the estate. This disparate treatment discriminates against individuals whose wealth is invested in family businesses.

It is my view that Congress never intended Section 2036(c) to permanently bar preferred stock freezes. Section 2036(c) originally was enacted as a part of the Omnibus Reconciliation Act of 1987 without the benefit of Congressional hearings. Its total revenue gain was projected at only $109 million over three years suggesting that the provision was directed narrowly at abusive freezes.

Indeed, the section was probably unneeded as it stemmed from the IRS' initial court losses challenging taxpayer's valuations in certain cases involving preferred stock recapitalizations. Rather than press its position in those cases, the IRS requested Congressional intervention. This intervention was premature. The IRS litigated the gift tax consequences of interest-free loans for many years before it was ultimately successful in having the Supreme Court rule that indeed gift tax consequences did result from such loans. However, Section 2036(c) was an easy way to pick up needed revenue.

Drafting the statute without hearings, however, was not so easy. The result was a statute which precludes legitimate business succession planning and ought to be repealed for that reason alone. However, there are a number of other reasons that make repeal of Section 2036(c) necessary.

First, Section 2036(c) is impossible to apply because essential statutory terms such as "enterprise," "disproportionate appreciation" and "in effect" transfers are so broadly defined so as to be meaningless. According to the House Report to the 1988 Tax Act, one must be able to determine the potential appreciation for all interests in the enterprise to know whether Section 2036(c) applies to a transfer. This is the equivalent of guessing how high the Dow Jones Industrial Average will go. The result is that an individual who owns two classes of common stock in a corporation cannot give either class without a fear that the gifted class will appreciate faster than the retained class. The IRS has the advantage of hindsight at the donor's death. Section 2036(c) also raises the specter that any other interest in the business such as a lease or employment agreement will result in a Section 2036(c) problem.

Second, Section 2036(c) targets family businesses. This places family businesses at a competitive disadvantage when compared to publicly-held or multi-national corporations. Legitimate business transactions and capital structures which are permitted publicly-held corporations are not permitted family corporations. Instead, the family corporation must conform its transactions to extremely confining "safe harbors." This discrimination is most evident in the application of Section 2036(c) to business interests purchased by family members at full fair market value (or even at a premium to fair market value).

Third, Section 2036(c) can apply to any gift no matter how insignificant the gift was at the time it was made. For example, stock worth $100 given as a Christmas gift at a time when the whole business was only worth $50,000 could 40 years later be included in the donor's estate when the stock is worth $100 million. In auditing these transactions the IRS has the advantage of hindsight, but it does not have the resources to monitor all family business transactions. Thus, the statute's application will be haphazard and unfair inciting litigation.

Finally, Section 2036(c) departs completely from property law concepts by treating a completed irrevocable gift as a continuing transfer. It further treats spouses as alter egos, imputing to each spouse the actions of the other.

The response to these criticisms that Section 2036(c) was overly broad and discriminated against legitimate family business transactions was the enactment of statutory safe harbors in the 1988 Technical Corrections Act. These are narrow exceptions to Section 2036(c) into which all family business transactions must fit. The safe harbors were drafted by Treasury and Congressional aides agreeing on the least common denominator, i.e. what everyone could agree were nonabusive transactions. The result was very narrow, complex exceptions to Section 2036(c) with arbitrary tests. For example, an employment agreement could last 3 years, but not one day more.

The safe harbors were intended to allow certainty in business transactions without the need to rationalize the statute and its legislative history. The committee reports state that no presumption is to be drawn that the existence of safe harbors imply the application of Section 2036(c) to other business transactions outside a safe harbor. Thus the question of the scope of Section 2036(c) was ducked in favor of "cookie cutter" estate and business plans. More of the same is promised as a 45 page notice excepting even more transactions from the section has been promised by the Treasury for more than a year. This process will continue indefinitely unless Congress repeals Section 2036(c) and its over-broad, general language.

This approach to narrowing the application of Section 2036(c) is the equivalent of me telling someone how to get to my house by describing everywhere in America that I don't live. No matter how well-traveled I am I will leave something out. And the people who draft these safe harbors are not well-traveled in the Business World.

A "safe harbor" sounds like a friendly, inviting, well-lit port of call. A "safe harbor" under Section 2036(c) is more like a rocky fjord or a slippery sandbar. The enlarged chart shows one such safe harbor for Qualified Debt to illustrate this point. (The Treasury Notice promises to be 45 pages like this—in finer print.) This is the safe harbor that parents must comply with if they loan money to a child to build a house or sell a family business or farm to a child on installments. You would think that in a transaction like this that the parent need only engage in an arms length transaction with the child. *Not the case.* If unrelated parties are involved, the lender need only go to the monthly notice issued under Code Section 1274 to determine the applicable federal interest rate which must be used to avoid a gift. Between family members not only must this rate be charged to avoid a gift tax, but the additional requirements of the safe harbor must be followed to avoid an estate tax.

Examining the safe harbor, we find that if the loan is not secured by real estate that its maximum duration is 15 years. Moreover, we learn that a demand loan is not permitted. We find it is impossible to understand the last requirement as it is so broadly worded. We also learn that the safe harbor implies that a security interest in the enterprise is permitted, but it doesn't say so specifically.

This is the problem with safe harbors. It is common with a statute to make judgments as to conduct which is within or without its scope. Such judgments are not possible with a safe harbor. You must fit precisely within the safe harbor. Expansion or clarification, therefore, can only occur through future IRS rulings.

The Qualified Debt safe harbor demonstrates how far afield Section 2036(c) has come from its original intent to preclude valuation abuses. If the loan involves a sale, then the value of the business is no easier to determine at the death of the owner than at the time the sale occurs. The only other valuation issue is the proper rate to charge and this is fixed by Section 1274. Section 2036(c) becomes merely a device to tax the purchaser on his own efforts.

The Qualified Debt safe harbor should not be confused with the Start-Up Debt safe harbor. This latter safe harbor prohibits a parent who provides "seed money" to a child to start a business from referring customers or clients to the business.

My father is a coal miner in Southern Illinois. I am at a disadvantage as far as client referrals go when compared to an estate planning attorney who might be the son of a president of a multi-national corporation. I don't expect, however, that an estate or gift tax will be imposed every time my competitor receives a client referral from his father, any more than I expect one to be imposed if a client is referred to me by my father. We might as well tax Richard J. Daley's estate for his son's election as mayor.

If we are going to experiment with broadening the transfer tax to reach inequality of parentage, let's not conduct that experimentation at the expense of family businesses.

Such an approach further departs from the notion that the estate and gift taxes are imposed on the transfer of property. Rather, the conferrance of benefits or, in the case of Section 2036(c), the potential conferrance of benefits, is taxed. Not only is this approach impractical, but it is of questionable constitutionality. As we know, direct taxes must be apportioned among the states. The estate and gift taxes are exempt from this requirement as a tax on the privilege on the transfer of property. Section 2036(c), in effect, taxes appreciation, not the act of transfer.

While I believe that the IRS would have been successful in attacking abusive freezes without the enactment of Section 2036(c), repealing Section 2036(c) in the context of Gramm-Rudman may not be as simple as never having enacted it. For that reason alone, it may be necessary to structure a replacement, such as lawyers in the American Bar Association are currently drafting. Such a replacement should target those gift tax valuations which are problematic. It might further attempt to define what is a reasonable return on the parent's capital invested in the business by analogy to the interest-free loan rules. A precise analogy, however, may be inappropriate as it may be desirable to limit that return to the income of the enterprise. Finally, it may be desirable to require reporting of transactions with potential for abuse, even though the taxpayer contends that no gift occurred.

Such an approach ought to enhance short-term revenue by imposing a gift tax rather than an estate tax. It also would enhance income tax revenues by permitting legitimate corporate freezes, thereby encouraging taxation of these "frozen" corporations as C corporations with their inherent income tax disadvantages.

Section 2036(c) is simply too intrusive into legitimate family business transactions. Ron Aucutt, a practitioner, offers an eloquent appraisal:

> What is wrong with statutes like section 2036(c) is that they are simply too intrusive into intrafamily relationships. Everyone knows that family members advise one another, affirm one another, and assist one another in innumerable ways. Such is the stuff of family. . . . When the only "transfer" involved is the intangible stuff of family, the transfer tax is better off leaving it alone.

Any replacement statute would have to avoid this intrusiveness and apply equally to all businesses.

The problem with Section 2036(c) is best stated by one of my clients, a farm owner in Bloomington, Illinois, and a doctor's wife. A few years ago, we created a farm partnership with her and her husband as general partners and their two children as limited partners. They wanted to bring their sons gradually into the operation, but wanted them to be limited partners so that they wouldn't be exposed to any liability for farm operations. When we created the partnership, we thought all assets had been conveyed. But, a few months ago, in fact almost a year ago, we discovered that we had left out about $3,000 worth of cooperative stock. Being very organized and careful, she insisted that we transfer the $3,000 worth of stock into the partnership. My advice was to wait for the IRS notice. Last week I was talking to her, telling her that the notice still hasn't been released. She said, "You know, taxpayers ought to be able to go about their business without worrying that two years later the IRS will decide something they did earlier was wrong."

Senators, it ought to be possible to make laws, even tax laws, impacting farmers and small businessmen understandable without notices, regulations, committee reports, floor colloquies, and, yes, even Chicago lawyers. You can't fix the entire code today, but certainly you can repeal Section 2036(c).

McDermott, Will & Emery,
June 23, 1989.

Senator Thomas A. Daschle,
Senate Hart Office Building,
Washington, DC.

Dear Senator Daschle: At the end of the Senate Finance Committee hearing on your bill, S. 849, you asked that the other witnesses and I submit recommendations on the replacement of Section 2036(c). This letter responds to that request.

THE SECTION 2036(C) "PROBLEM"

The Senate Finance Committee hearing record contains an example (adapted below) of the "problem" addressed by Section 2036(c):

> X owned a large block of stock in a public company worth approximately $8 million if valued on a per share basis at its trading value. X formed a new holding company to own X's stock ("Newco") exchanging the stock for $6.9 million in preferred stock. The preferred stock paid a 6% noncumulative dividend and could be redeemed at its liquidation value. X's children put in cash and received common of equal value in exchange. Three years later when the $8 million in stock is worth $28 million dollars it is sold.

The example is intended to raise a number of concerns about this transaction if Section 2036(c) is repealed, but most of those concerns have nothing to do with Section 2036(c):

1. *Business Valuation.* Section 2036(c) was not directed at the blockage discount (by which the $8 million in publicly-held stock is valued at $6.9 million) raised by the example. The gift tax is an excise tax on the privilege of transferring property measured by the fair market value of the property transferred. If the stock would sell for $6.9 million, then its gift tax value is $6.9 million. While no one would suggest that gift tax value should exceed fair market value, this is precisely the result under Section 2036(c). Everyone recognizes that the valuation of a closely-held business is problematic, but Section 2036(c) does not address this problem. Moreover, valuation is primarily a question of fact best answered by IRS enforcement, negotiation and court determination.
2. *Preferred Stock Valuation.* Section 2036(c) was directed at the taxpayer's claim that the value of the preferred stock received equaled the value of the common stock transferred. Valuation is inherently a factual question, and the lack of facts make it impossible to determine the preferred stock value. For example, the public stock may pay only a 1% dividend while the preferred stock pays a much higher rate. The business may have insufficient dividend paying capacity so that the stock is worth less than its liquidation value, perhaps much less. In that case, the recapitalization results in a substantial gift to the children common shareholders. In fact, in the example no conversion or other right to support the liquidation value specifically is mentioned, thus it is almost certain that the value of the preferred is not its liquidation value. The value of the preferred should be measured by its objective fair market value standard, and this value should not be ignored as it is by Section 2036(c).
3. *Arms-Length Transactions.* Apparently, the focus of IRS concern is the use of conversion, redemption or other rights to support valuing the preferred at its liquidation value when those rights may not be exercised in an arms-length manner. *Dickman* v. *Commissioner,* 465 U.S. 330 (1984) (discussed below) proves that the courts will find a gift if the parties do not act in an arms-length normal business manner. In *Dickman* the taxpayer failed to demand a market

interest rate on a loan. However, family members need not always exercise discretionary rights in a way that produces the worst transfer tax result. Under *Dickman* the loan need not be usurious. The IRS, on the other hand, argues that a noncumulative dividend on preferred stock must be paid even if the payment would be illegal or violate fiduciary duties owed minority shareholders. The proper test is whether the family members act as unrelated parties would act.

4. *Nature of Investment.* Section 2036(c) was not directed at the fixed return on X's investment or the family's co-investment in the same company. Older individuals frequently invest more conservatively than younger individuals. Surely no one is required to earn a minimum return on his or her capital. Section 2036(c) is not directed at prohibiting a parent from owning preferred stock in a public corporation in which his or her children own common. Section 2036(c) does not apply unless X's family owns at least 10% of the company.

5. *Post-Gift Appreciation.* The final problem identified by the example is that the stock appreciated in value from $8 million to $28 million dollars. Again Section 2036(c) is not directed at this problem. While it is true that Section 2036.(c) would have pulled the appreciation back into the parent's estate, Section 2036(c) would not have applied if the $8 million of stock had been gifted for $6.9 million or sold to the children for that price. It is the nature of a gift that the value is measured at the time the transfer occurred by the objective fair market value standard. Appreciation, therefore, escapes taxation in the donor's estate. Instead, that appreciation is taxed in the donee owner's estate. Section 2036(c) is designed to tax the same appreciation *twice.* It is wrong to suggest that somehow this is "gamesplaying" or "tax avoidance." It is simply the nature of a transfer tax. The estate and gift taxes are excise taxes on the privilege of transferring property measured by the fair market value of the property transferred. Section 2036(c) on the other hand, imposes a gift tax measured by the value of the property at the donor's (or donor's spouse's) death *at a time when no transfer occurs.*

Section 2036(c) creates a troubling dichotomy. If an individual retains a frozen interest, every valuation is presumed abusive. All appreciation is pulled back into the estate. This penalizes every business owner for the abuses of a few. This discriminatory treatment precludes family owned businesses from adopting capital structures comparable to those of publicly-traded businesses. If an individual retains no frozen interest, 'then no valuation is abusive as Section 2036(c) does not apply.

Another reason sometimes advanced to justify the date of death valuation test in Section 2036(c) is that continual hard-to-detect transfers are occurring. However, Section 2036(c) presumes conclusively that all hard-to-detect transfers exist in family businesses and that all of the appreciation is attributable to such transfers. Again, every business owner is penalized for the abuses of a few. On the other hand, it is not only those adopting a frozen capital structure who are caught by Section 2036(c). A very wealthy person could gift assets to his or her children and have the children establish a corporation wholly owned by them. By uncompensated service or by transfer of ideas and business opportunities a parent could make hard to detect transfers which are will not be caught by Section 2036(c). If a hard-to-detect transfer occurs, the easiest time to detect such a transfer is at the time it occurs. More importantly, if hard-to-detect transfers are a substantial concern Section 2036(c) is an inappropriate response.

REPLACEMENT OF SECTION 2036 (C)

Designing a replacement for Section 2036(c) is a difficult task.

Although it is most frequently described as an attack on *abusive valuations,* Section 2036(c) applies even though the value is correctly determined. Another purpose sometimes put forward is that the retention of income and vote in a family business through retained preferred stock is similar to other types of transfers with retained interests included in the estate under Section 2036(a). However, the IRS wants more of these retained interests to support the claimed value of the preferred. Moreover, in all of my discussions no one has suggested that forcing the founder of a family business out of that business was desirable as a matter of tax policy.

It seems more likely that Section 2036(c) is simply an anomaly produced by the Gramm-Rudman budget law. The attraction of the revenue gain from enacting Section 2036(c) simply overwhelmed those who believed that the courts ought to decide the issue. After all, from a Gramm-Rudman perspective a court decision precluding abusive valuations has none of the revenue benefits of a statute reaching the same result.

It now appears that the IRS will be successful in challenging abusive freezes without Section 2036(c). Tax Notes Today carried the following piece:

> *Taxpayers' unbroken streak of victories in pre-1987 Act estate freeze cases is about to end, said estate planning expert Richard B. Covey of Carter, Ledyard & Milburn, New York, NY.* At an April 17 National Law Foundation seminar on estate freezes, Covey noted that Tax Court cases involving Elizabeth W. and Ritchie A. Snyder (docket nos. 289640–87 and 28965–87) involve two issues. The first issue is the straightforward estate freeze question: did Mrs. Snyder, who created a holding company by transferring common stock of a closely held corporation in exchange for holding company common and preferred stock, make a taxable gift when she gave the common stock to her children? The second issue concerns the reach of the Supreme Court's gift loan decision in *Dickman* v. *Commissioner,* 465 U.S. 330 (1984). The Snyder case is important only for transfers before the effective date of section 2036(c), which imposes transfer taxes on both the recapitalization and the continuing gift. [Emphasis Added]

The quick enactment of Section 2036(c) should be compared with the long and ultimately successful attempts by the IRS to treat the foregone interest on interest-free loans as a gift. The judicial challenge lasted for more than a decade culminating in the 1984 United States Supreme Court decision in *Dickman* v. *Commissioner,* 465 U.S. 330 (1984) holding that such loans were gifts of the use of money. Only after that decision did Congress enact the applicable federal rate specifying a definite measure for the gift.

Although the statutory concept of these interest-free loan rules enacted in 1984 was sound and unlike Section 2036(c) the rules were tightly crafted, these complicated rules no longer work as expected five years later due to a flattening of income tax rates, a failure to issue final regulations, a number of technical correction statutes and the lack of coordination between the 1984 act with the 1986 act interest deduction limitations. I recite this history only to suggest the risks in substituting a complex inflexible statutory solution for a flexible judicial solution.

Accordingly, if Gramm-Rudman requires a replacement of Section 2036(c), my approach and the one I would recommend to Congress is to attack the problem as one of administration of our tax laws and not one demanding more tax laws.

REPLACEMENT STATUTE

For the above reasons Section 2036(c) is an inadequate answer to the valuation problems inherent in gifts of nonpublicly traded property. A replacement statute should not be limited to attacking abusive valuations in estate "freezes." It should attack all attempts to disguise or hide gifts or to play the gift tax audit lottery. A combination of inducements to disclose transfers on gift tax returns and for the IRS to audit such returns and penalties for overaggressive valuations should produce an acceptable mix to replace Section 2036(c).

It has been suggested that the disclosure approach is an unacceptable substitute for Section 2036(c). However, the disclosure option proposed here goes much further than any previously proposed. The IRS has expressed its concern about disclosure proposals which require the IRS to audit gift tax returns simply by reason of disclosure. My proposal responds to this concern. The IRS would be free to wait to audit gift tax returns until the donor's death, except for those gift tax returns which would result in tax by reason of the audit. This is a significant concession by taxpayers. My proposal also incorporates the valuation understatement penalty to discourage taxpayers from playing the audit lottery. My proposal presumes that the penalties will be overhauled (as has been proposed) so that their application is fairer.

Here are my specific suggestions:

1. *Suspend Assessment Period on Unreported Gifts.* The period for assessing a gift tax deficiency on a 1989 gift tax return or later return would remain open for transfers not disclosed on a gift tax return until the close of the period for assessing the donor's estate tax. This would mean that no donor could ever be free from gift tax liability except by disclosing the transfer. Moreover, gift tax might be due and interest payable thereon for many years. This is such a draconian measure that a ten year limit, a *de minimis* rule, a good faith exception, an exception for routine business transactions or simply adjusting later transfer tax returns as provided below perhaps should be incorporated into the proposal.
2. *Allow Adjustment of Taxable Gifts in Later Audits and for Waiver of Unified Credit.* The IRS would be able to audit any gift tax return after 1976 for the purpose of increasing the amount of taxable gifts in a subsequent estate or

gift tax return. No credit would be allowed for the increased taxable gifts. (A one year grace period for disclosing unreported pre-1989 gifts.) Accordingly, higher gift and estate tax would result in those later returns. However, the IRS would be precluded from reopening a gift tax return more than three years after filing to increase the value of a transfer in the gift tax return under the following circumstances:

a. The transfer was disclosed on the gift tax return.

b. The taxpayer waived the use of unified credit on the return or the unified credit was exhausted.

One of the problems of providing a disclosure based alternative to Section 2036(c) is that those alternatives often failed to provide a sufficient incentive to the IRS to audit gift tax returns. If the unified credit is waived and the transfer is red flagged, the IRS is certain to collect tax on audit. The transfer tax rate structure also will need to be revised. The true minimum transfer tax rate is 37% which is the rate which applies once the unified credit is exhausted. Thus lower stated transfer tax rates will have to be raised to this minimum so that the waiver of unified credit will not result in a lower tax.

3. *Application of the Understatement Penalty.* If the adjustment in a prior gift tax return would have been subject to the valuation understatement penalty, then tax due in a later gift or estate tax return attributable to the adjustment in taxable gifts also would be subject to the penalty. Extending the penalty to transfers reported in prior years' returns means that taxpayers will have to obtain independent valuations to ensure that the gifts are valued properly even in those circumstances where it is inconceivable that any gift tax could result. This is precisely the burden IRS wishes to avoid. Thus, the penalty should not apply in a later return if the transfer was disclosed previously. However, disclosure would not avoid the undervaluation penalty in the year in which the gift is reported.

4. *Reporting Sales and Similar Troublesome Transfers.* To the extent provided in regulations, (a) consideration paid by a descendant or spouse of a descendant and (b) the annual exclusion would be disregarded in determining whether a substantial valuation understatement has occurred, unless the nature of the transferred property and the consideration paid and exclusion claimed was disclosed. In other words, if a sale was not disclosed and it later was determined that the property sold was undervalued by the requisite percentage, then the amount of consideration paid would not affect the determination of whether a substantial undervaluation occurred or the computation of the tax attributable to the undervaluation (other than by limiting the total deficiency). This change also would adversely impact taxpayers who disguise gifts of difficult to value interests by reporting cash gifts and then turning around and selling the interest for the gifted cash.

My disclosure proposal would allow the IRS to audit all of a decedent's transfers in an estate tax audit, other than those transfers which were disclosed on a gift tax return in which the unified credit was waived. Further, taxpayers who played the audit lottery and who used abusive valuations would be subject to the undervaluation penalty.

My proposal ought to result in revenue increases in the Gramm-Rudman years over the revenue attributable to Section 2036(c). First, Section 2036(c) operates at the death of a donor thereby deferring its revenue effect. The proposal will encourage disclosure and more conservative valuations. In addition, the potential application of the undervaluation penalty is broadened. Second, the ability to waive unified credit will result in increased gift taxes immediately. Third, by permitting certainty the proposal will encourage gifting and increase the amount of gift taxes paid. Fourth, the one year grace period for reporting previously undisclosed transfers ought to result in gift tax audits and increased collections. Fifth, the repeal of Section 2036(c) will encourage multiple class C corporations to continue and pay substantial dividends, rather than convert to S corporations for income tax purposes. This will result in significantly higher corporate income taxes being paid.

More attractive than the revenue benefit from the proposal is the rationalization of tax policy. First, the proposal does not discriminate against family businesses. It applies equally to all difficult valuation situations. It permits family companies to engage in the same transactions permitted publicly held companies. Second, the proposal penalizes only those taxpayers who indulge in abusive valuations or otherwise play the audit lottery. Third, the proposal is simple and unambiguous. Fourth, the proposal is not limited to abusive valuations in the context of a particular type of corporate capital structure. Fifth, and most importantly, existing Section 2036(c) ought to be repealed retroactively.

SAFE HARBOR RECAPS

One particularly noteworthy aspect of the American Bar Association proposal and others is the creation of a safe harbor for certain recapitalizations which are clearly nonabusive. This should be adopted together with the disclosure reforms. Such a safe harbor recognizes that preferred stock recapitalizations are not inherently abusive. It would be beneficial for the many business owners who desire to pass their businesses on to family members. Business owners generally appreciate safe harbors for their certainty. However, Section 2036(c) contains safe harbors which are so narrowly constructed and unrealistic as to be useless. The recap safe harbor is clearly more realistic and therefore more useful.

The safe harbor ties the required rate of return to the applicable federal rate. This makes sense as the rate is used to define a minimum return on capital on cash loaned between family members. In a sense the recapitalization is a loan of the family business to the active family members. The use of the applicable federal rate ensures a minimum return for that capital.

My only concern about tying the return to the applicable federal rate is that many family businesses have insufficient return to support this size dividend. Indeed, in many such businesses the payment of a dividend of that scale would be illegal. How can a business have a value which would not produce a rate of return equal to a short term Treasury bill rate? Because the IRS so frequently argues for liquidation value of family businesses rather than their "going concern" value. The public markets reflect this in the "breakup value" which is many times the trading value before the breakup is announced and in the premium paid for possible takeover targets.

Thus the use of a safe harbor applicable federal rate is not a failure of the safe harbor but reflects the failure of the IRS to properly value family businesses at "going concern" value. My preference would be for a valuation statute which mandated "going concern" valuations for all family businesses with a recapture of estate tax savings if the family business is sold. Such a statute would resemble Section 2032A which authorizes a similar valuation technique for farms and other realty businesses. Section 2032A, however, was enacted prior to the enactment of Gramm-Rudman when tax policy not revenue was the overriding consideration. A limited solution would be to expand the safe harbor to accommodate small businesses with low returns.

Another beneficial aspect of the safe harbor is that most recapitalizations will attempt to comply with the safe harbor. The new disclosure rules will make deviating from the safe harbor risky. This will increase the revenue gains from enacting the replacement.

STATUTORY VALUATION

It is my view that no statutory valuation provision is needed with the disclosure reforms and safe harbor set forth above. However, the American Bar Association Tax Section and others in attempting to address vaguely defined Congressional staff concerns have developed a laudable statutory valuation provision. This provision would require that in valuing certain family business interests it would be conclusively presumed that any discretionary powers affecting valuation would not be exercised adversely to the transferee's interests. Thus the value of the gifted property would be increased.

The advocates of this approach have dealt creatively and diligently with this difficult drafting project to produce a draft which is vastly superior to present Section 2036(c) while addressing all of the stated objections of staff. However, any statutory valuation approach will fail to satisfy the desirable tax policy objectives set forth above. Instead, it would be designed only to address staff concerns. First, this approach targets family businesses for special adverse rules. Second, this approach penalizes taxpayers who exercise discretionary rights in an arms-length manner as well as those taxpayers who do not. This presumption of malevolence directed at family business owners discourages respect for the tax laws. Third, this approach is complex with a number of new definitions. Fourth, this approach does not deal with the problem of abusive valuations in a general way, but like Section 2036(c) is limited to multiple class corporations. Of course, this last point is strictly a tax policy issue and not a valid criticism for a replacement statute.

OTHER VALUATION QUESTIONS

Section 2036(c) has been applied to attack other transactions which the IRS considers abusive despite its original narrow purpose. The estate and gift tax consequences of other types of "freezes" are controlled by other tax rules so that the Section 2036(c) requirements are piled on top of the other requirements which already sufficiently ensure proper valuation. Only the valuation of preferred stock lacked similar guidelines. Some examples are discussed below:

Debt Instruments—As discussed above, in 1984 Congress enacted the applicable federal rate as an objective measure of the rate to be imposed on loans between family members by implication of the "qualified debt" safe harbor. The application of Section 2036(c) to debt is inconsistent with this provision and likely to result in considerable litigation.

Buy-Sell Agreements—The estate tax consequences of buy-sell agreements are determined by Treas. Reg. Section 20.2031-2(h). These regulations have been upheld by the courts. *See, e.g., St. Louis County Bank* v. *United States,* 674 F.2d 1207 (8th Cir. 1982).

Successive Interests—The value of successive interests, such as life estates and remainders, are determined under Treas. Reg. Section 20.2031-7. The value of a remainder is measured against a floating discount rate determined monthly. The 1988 Tax Act provided for the floating rate and it is ludicrous to suggest that Congress' actions were insufficient to solve any abuse which might have existed.

It is wrong to single out family businesses for expansion of these requirements when the existing law places sufficient restrictions on these devices to ensure proper valuation.

Please let me know if you have any questions regarding this letter or my proposal. I would welcome the opportunity to work with staff to develop an acceptable alternative to replace Section 2036(c).

Very truly yours,

RICHARD L. DEES

Enclosure.

Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases

By **RICHARD L. DEES**

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Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases

By RICHARD L. DEES*

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I. *The Creation of Frankenstein's Monster*

The search for noncontroversial revenue sources in the compromise which produced the 1987 budget led to the enactment of new Section 2036(c) of the Internal Revenue Code of 1986 (hereinafter Code), which ended the estate tax benefits of retaining preferred stock while gifting common stock.[1] This technique had permitted a business owner to pass future appreciation to a younger generation in the business, thereby "freezing" the estate tax value of the business while preserving income by a dividend preference and security by voting control. Although these transactions had been commonly used for decades as a means of succession from one generation of business owners to the next, the Internal Revenue Service had adopted the view that these common family business transactions were abusive. The Tax Court's rejection of this view in *Boykin Estate*[2] prompted the IRS to seek congressional intervention.

The initial House bill contained a valuation provision denying discounts for minority interests in a family business and the "anti-freeze" provision.[3] An unsympathetic Senate eventually compromised by agreeing to end the preferred stock freeze by enacting Code Section 2036(c) as part of the Revenue Act of 1987 (hereinafter 1987 Revenue Act) in exchange for the retention of minority discounts. This was perceived as a fair compromise, as the discount provision was perceived as affecting many more family businesses than the preferred stock limitation.

Moreover, the Senate was able to obtain important concessions in the statutory language. The valuation approach was replaced by a testamentary inclusion approach modeled on Section 2036 (which includes in the gross estate transferred property which the transferor continues to enjoy for life). The initial House provision had applied to transfers within a generation while the final bill applied only to transfers between successive generations.[4]

Most important, the House provision had applied to *transfers of appreciation*[5] while the final bill required a *transfer of property having a right*

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[*] This article is dedicated to my wife Christina and my children, Sarah and Elliott, who have been widowed and orphaned since the 1988 Technical and Miscellaneous Revenue Act was passed on October 21, 1988.

Appreciation is expressed for the guidance of my partner, James M. Trapp, the tolerance of my partner, Carol A. Harrington, the assistance of my colleagues, William J. Butler and David A. Lullo, and the perseverance of my secretary, Kathy Podraza.

[1] Revenue Act of 1987, Sec. 10402(a). This act is referred to herein as the 1987 Revenue Act.

[2] CCH Dec. 43,764(M), 53 TCM 345 (1987).

[3] Bill Sec. 2211, as passed by House Ways and Means Committee (October 15, 1987). This bill is referred to herein as the 1987 House Bill.

[4] 1987 House Bill, Sec. 2211(a)(2)(B)(i).

[5] 1987 House Bill, Sec. 2211(b)(1)(B).

to disproportionate appreciation.[6] As a concession the Senate agreed that the bona fide sale exception in Section 2036(a) would not apply to sales to family members.[7] Instead, a consideration offset divorced from Section 2043 would be developed to reduce the estate tax value of the Section 2036(c) inclusion.[8] As we will see later, some of the concepts from the House bill have not been as completely excised from the discussions of Section 2036(c) as from its statutory language.

The *Boykin* decision had reaffirmed the principle established by the Supreme Court in the decision of *Byrum v. United States,*[9] which held that the retention of the vote of corporate stock was not retention of its enjoyment for federal estate tax purposes under Section 2036. Section 2036(c) modified *Byrum* by providing that the retention of income or certain corporate rights in business would result in gross estate inclusion if the transferred stock had a disproportionate right of appreciation. The nature of Section 2036(c) was clearly delineated in the legislative history:

> Under the conference agreement, if any person holds a substantial interest in an enterprise and in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise, then the retention of the retained interest is treated as a retention of the enjoyment of the transferred property.
>
> . . . The provision only makes certain property includible in the estate; it does not affect the valuation of such property for estate tax purposes.[10]

No congressional hearing was ever held on the public policy issues involved in eliminated preferred stock "freezes," other, less intrusive, approaches to dealing with abusive freezes or alternative statutory language. Thus, no practical opportunity was presented for outside comments from the practitioners most familiar with these transactions. Rather, the statutory provision was drafted from a perspective of those who had seen only abusive freezes. The statutory approach and language changed dramatically in a two-month period from October 15, 1987 to enactment on December 22, 1987. Thus, another Frankenstein's Monster was born.

Not too surprisingly, the statutory language drafted under such constraining circumstances during this two-month period came under immediate attack. That attack should have been directed at the failure of the statute to apply to the most egregious freezes.[11] Commentators instead chose to focus on the possibility that the broad statutory language of Section 2036(c) might be applied outside the narrow purpose delineated in its legislative history. For every well-meaning but ill-conceived theory advanced, someone in Washington was willing to assert that, of course, Section 2036(c) applied and it was drafted that way intentionally. Thus grew the Monster.

If outlandish theories fed the Section 2036(c) Monster, the 1988 Tax Act sheltered it. The 1988 House Report[12] resurrected the valuation approach, which was completely different than the testamentary approach of Section 2036(c), as enacted:[13]

> Section 2036(c) is directed at two concerns. The first is that the creation or transfer of disproportionate interests in a business or other property often allows the transfer of wealth outside the transfer tax system, either because of undervaluation at the time of the effective transfer or because of action or inaction of the transferor or transferee after that transfer.
>
> Undervaluation may occur because the transferor claims a value for the transferred property lower than its fair market value. Undervaluation may result from the transferor granting a person a long-term option to purchase property at a fixed price.
>
> Creation of disproportionate interests in property also permits the transfer of wealth free of transfer tax through the subsequent exercise or nonexercise of rights with respect to the enterprise. Even if the transferred property is properly valued at the time of the initial transfer, wealth may be transferred thereafter if the rights are not exercised in an arm's-length manner. . . . Even if such exercise or nonexercise results in a gift, which is uncertain, it is virtually impossible for the IRS to monitor all post-transfer action or inaction with respect to such rights.
>
> The second concern underlying Section 2036(c) is that, by retaining a disproportionate share of the income of, or rights in, an enterprise, the transferor in fact retains enjoyment of the whole enterprise. The trans-

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[6] IRC Sec. 2036(c)(1)(B). The Internal Revenue Code is referred to herein as "Code."

[7] IRC Sec. 2036(c)(2).

[8] IRC Sec. 2036(c)(1).

[9] 72-2 USTC ¶ 12,859, 408 U. S. 125 (1972).

[10] House Conference Report No. 100-495 at 995-96. This report is referred to herein as the 1987 Conference Agreement.

[11] One of the requirements of the 1987 Act with which you will soon become very familiar was a requirement that the retained income or rights be disproportionate. IRC Sec. 2036(c)(1)(B). This requirement was removed by the Technical and Miscellaneous Revenue Act of 1988, Sec. 3031(e), referred to herein as the 1988 Tax Act. The 1987 Revenue Act permitted the creation of an "unpreferred" preferred stock which had the same vote and dividend rights as the common, but a fixed liquidation value. If the common was gifted, then the retained rights and income were arguably not disproportionate.

[12] House Report No. 100-795 (July 26, 1988).

[13] 1988 House Report at 422-23.

fer is incomplete at the time of the initial transfer, and if enjoyment is retained until death, the transfer is testamentary in nature.

This Mr. Hyde-like sinister shift in the 1988 legislative history was not reflected in the Dr. Jeckyll-like calm demeanor of the statute. "Safe harbors" were added to the statute to protect taxpayers who wanted certainty, but the sinister side suggested that somehow these safe harbors expanded the scope of Section 2036(c). The requirement of "disproportionate" retention of income or rights was struck from the statute so that the most egregious freezes would be caught. A "deemed gift" rule was added to the statute. The House proposed minor technical changes purporting to apply Section 2036(c) to tax savings devices without enacting the broad statutory language necessary to bring those devices within its gambit. The rumblings of Mr. Hyde's sinister side in the legislative history eventually were betrayed by Dr. Jeckyll's tame statute.

II. *Structure of Article*

The 1988 Tax Act left unanswered several crucial questions:

(1) What are "retained interests" in an "enterprise?"

(2) What is "disproportionate appreciation?"

(3) Does Section 2036(c) catch retained interests which do not involve ownership?

(4) When has a "transfer of property" occurred?

(5) How does the consideration offset operate?

(6) How is the Proportionality Rule applied?

This article discusses the proper answers to these important questions in the context of common business and estate planning transactions.

Useful examples of such transactions must be simple. Real life transactions are seldom so. Section 2036(c), however, is a highly stylized view of a family business. In the view of its drafters, businesses never decline in value, every business transaction has the avoidance of estate tax as one of its purposes and the owners have a cleanly delineated set of rights in the business. In the few months I have been reviewing business transactions under Section 2036(c), not a single transaction from my practice falls neatly within the facts of the transactions discussed below.

The following discussion incorporates the 1988 Tax Act changes. Of particular importance are areas where further guidance from Treasury is needed immediately. These are highlighted by appearing in italics.

Finally, the examples refer to "P" (parent), "S" (spouse), "C" (child) and "Corp," "Partnership" or "Trust" (enterprise). The references in the examples to percentages of different classes of stock, unless otherwise specified, refer to the percentages of that class of stock, not the percentage of a class owned by a particular person. It is further presumed that all of the aspects of a transaction occur after December 17, 1987, unless otherwise stated. The appendix to this article summarizes these transactions; however, given the uncertainties inherent in the statute, little solace is gained by the difference between "probably not included" and "probably included."

In the preparation of this article, it has been my intent to focus solely on the statutory language and supporting legislative history in applying Section 2036(c) to the transactions. My conclusion as to the breadth of Section 2036(c) is much narrower than the breadth imagined by others. This is a luxury afforded me as a commentator, but denied me as an estate planner. Mr. clients can ill afford relying on my cogent analysis if a less risky "safe harbor" exists. For this reason the law under Section 2036(c) will develop haphazardly. Well-informed planners will avoid its reach. Only the ill-informed and aggressive will directly challenge the breadth of the statute. The audit lottery will mean that many of both the ill-informed and aggressive will escape detection. Litigation by both will resolve limited questions as to its scope. This process could continue for years.

At some point, however, it will be apparent that the only consistent answers to the six imponderable questions set forth above dictate a narrow scope to the statute. Rather than admit this eventuality, the 1988 Tax Act further obfuscated the answers to these questions. Thus thrives Frankenstein's Monster.

III. *Impact of Section 2036(c) on Common Estate Planning and Business Transactions*

A. Transactions Involving Corporations. *1. Gift of Common with Retention of Preferred.* P owns all of the common and preferred of Corp. P gives all of the common to C, paying a gift tax.

The Five-Factor Test

This is the only transaction which the legislative history accompanying the enactment of Section 2036(c) specifically states is caught by the five-factor test for gross estate inclusion under Section 2036(c):

(1) an individual and his family have a 10 percent interest

(2) in an enterprise

(3) and the individual in effect transfers

(4) property which has disproportionate rights to appreciation

(5) while retaining income or rights in the enterprise.

The 1988 Tax Act made only a limited change in the five-factor test, eliminating the prior requirement that the retained income or rights be disproportionate.[14]

The statute provides several important definitions. The 10 percent test is met if either or both of voting power or income stream is owned by the family.[15] The definition of family includes the spouse of a person, that person's parents and grandparents, the lineal descendants of the person and of the person's spouse and the spouse of any person who would be a family member.[16] However, the statute fails to define such important terms as "enterprise," "disproportionate," "income stream," "rights" and "transfer." Reliance on legislative history is required.

Because this transaction is caught by the five-factor test, the common gifted to C is included in P's gross estate at its then value.[17] The taxable gift with respect to the common is excluded from "adjusted taxable gifts" so as to avoid double taxation.[18]

2. Sale of Common with Retention of Preferred. P instead sells the common of Corp to C for its full fair market value.

The Bona Fide Sale Exception

Section 2036(c)(2) provides that a bona fide sale by P to C (or any other family member) will not preclude inclusion in P's gross estate. This is an important distinction between the operation of Section 2036(c) and Section 2036(a) and (b).

The 1988 Tax Act made an important change in the 1987 Revenue Act's nonexception for bona fide sales.[19] If the consideration paid by C (or another family member) was never derived from P (or P's spouse), then a sale for full fair market value would result in exclusion from P's gross estate. (A part-sale and part-gift results in proportionate exclusion.) This provision obviously favors the very wealthy, those family members with a source of wealth outside the family business, and the creation of long-term trusts with nonenterprise assets to provide future generations with a source of wealth for enterprise purchases.[20]

If the consideration is traceable to P, on the other hand, then the value of the gross estate inclusion is reduced only by the consideration received. It is generally understood that after the passage of the 1988 Tax Act no income or appreciation attributable to this consideration reduces the gross estate inclusion following the approach under Section 2043.

This was not understood prior to the 1988 Tax Act, and it still may be possible to argue that growing the consideration is permitted. Section 2036(c)(5) provided prior to the 1988 Tax Act that "in lieu of applying Section 2043, appropriate adjustments shall be made for the value of the retained interest." It was hoped that Section 2043 was not applied directly because of a desire to adjust the value of the consideration received as a part of the "retained interest." The 1988 Tax Act expanded on this theme and specifically requires adjustments to be made for the value of the retained interest, extra-ordinary corporate distributions and other corporate changes impacting the value of the ***retained interest.***[21]

Section 2043 results in an offset against the value of the ***transferred property.*** The reference to "retained interest" in Section 2036(c) most likely referred to the consideration received as part of the retained interest.[22] The value of the retained interest is completely independent from the value reduction attributable to the consideration provided by the purchaser, unless, of course, the consideration provided is an enhancement in value of the retained interest. *In order to restore meaning to this language, Treasury ought to permit an offset for the increased income and appreciation in the consideration under this Section 2043-like offset.*

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[14] 1988 Tax Act, Sec. 3031(e).

[15] IRC Sec. 2036(c)(3)(A).

[16] IRC Sec. 2036(c)(3)(B).

[17] Section 2036(c) provides that "the retention of the retained interest shall be considered to be the retention of the enjoyment of the transferred property" resulting in inclusion under Section 2036(a), which applies to "all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . ." Obviously, the gifted common is the transferred property for purposes of both subsections. The retained preferred, in the absence of a provision specifically excluding the preferred from its application, is included in the gross estate under Section 2033 as property of the decedent. Although these conclusions are fundamental to the application of Section 2036(c) and the statute admits of no other interpretation, there is indirect evidence of confusion on this point in the legislative history and in tangential parts of the statute.

[18] IRC Sec. 2001(b) (flush language).

[19] 1988 Tax Act, Sec. 3031(g).

[20] The actual application of this test is somewhat muddied by the legislative history as discussed below. At the very least, however, it permits the consideration paid to appreciate by the same rate as the gifted common.

[21] Id.

[22] Another possible, but strained, reading of the legislative history, is that the preferred stock retained by P is includible in P's gross estate under Section 2036(c). See note 17, above. This would contradict the 1987 Conference Agreement (at 996), which provides:

> Thus, if a person who owns a substantial interest in an enterprise and whose only holdings in the enterprise consist of 100 shares of common stock and 100 shares of preferred stock transfers 80 shares of the common stock and 20 shares of the preferred stock, *only 60 shares of the transferred common stock are included in his estate under this provision.* [Emphasis added.]

A provision in the 1987 House Report reached the same result (at 1044):

> For example, A owns 100 percent of both the preferred and common stock of a business. He makes a gift of 80 percent of the common stock and 20 percent of the preferred stock to his children. . . . *The value of all stock, preferred and common, transferred to his children would be included in A's estate.* [Emphasis added.]

Although this strained reading would explain the use of the words "retained interest" in Section 2036(c)(5), it would fly in the face of the literal language of the statute and the quoted legislative history. Accordingly, the explanation offered above that the language contemplated an adjustment in the consideration received (as a part of the interests "retained" by the transferor) to reflect increases in value, whether that consideration was cash or enterprise interests, is the more reasonable statutory interpretation.

3. The Classic Recapitalization. P owns all of the common stock of Corp. P makes a gift of 10 percent of the common to C and pays a gift tax. P then exchanges common for preferred of equal value.

What Is a Transfer?

It is generally presumed that Section 2036(c) catches this recapitalization, and, indeed, it does if a gift results from the transaction or a gift is part of the same transaction. The more interesting question is whether the five-factor test applies if the acquisition of the common stock by C is not part of the same transaction.

Factor 3 of the test requires a "transfer." The legislative history defines a transfer as encompassing:[23]

> [A]ll transactions whereby property is passed to or conferred upon another, regardless of the means or device employed in its accomplishment.

Both this definition and the statute require the passage of *property* from P to C. It is this transferred property which is included in P's gross estate.

If the value of the common surrendered exceeds the value of the preferred received, as the IRS frequently alleges in these recapitalizations,[24] then property has passed from P to C via a gift to Corp. In addition to the gift tax which might be due under such circumstances, Section 2036(c) would continue to result in inclusion in the gross estate of P the value of the property transferred by gift and its future appreciation. This means a valuation difference exacts an entirely new tax penalty than existed prior to the enactment of Section 2036(c).

On the other hand, if P has properly determined the value of both the old common and new preferred, then the exchange of one for the other could not result in a transfer of property to anyone. Thus, under these circumstances it appears that the classic preferred stock recapitalization remains viable. It must be noted, however, that any later transfer, whether inadvertent or intentional, would result in the inclusion of the transferred property in the gross estate under Section 2036(c). Here the exercise or nonexercise of rights granted to the preferred holder might be considered a transfer to the common shareholders.

The government's argument that such recapitalizations are caught by Section 2036(c) would require a two-step analysis. First, the transfer of old common by P to Corp was a transfer of property to Corp which indirectly was a transfer of property to C. Second, the transfer of preferred to P from Corp was consideration from Corp indirectly provided by C. This consideration, the IRS's argument would proceed, exempts the transaction only to the extent permitted as an offset under Section 2036(c).[25] Finally, in order to complete its argument, the IRS would have to conclude that the transferred property, old preferred, was now the old common held by C, so that a portion of the old common would be includible in P's gross estate as transferred property.

This line of reasoning is unsustainable. C has exactly the same property before and after P's transaction. This is a disguised attempt to reinstate the 1987 House Bill, which required only a transfer of "appreciation." Rather, Section 2036(c), as enacted, requires a transfer of property.

4. Short Freeze. P owns all of the common and preferred stock of Corp. P gives 50 percent of the common to C. Five years later P visits his lawyer, who tells P about Section 2036(c) and recommends that P give 50 percent of the preferred to C to restore proportionality.

The Deemed Gift Rule

The 1988 Tax Act added a deemed gift rule to Section 2036(c),[26] establishing a second important distinction between Section 2036(a) and (b) and Section 2036(c). Because transfers under Section 2036 are included in the gross estate as "testamentary" in nature, the failure to retain the prohibited interest until death is considered ample evidence of a nontestamentary purpose. Section 2036(c), as we learned in the 1988 legislative history for the first time, has a second, purportedly even more important, purpose and, accordingly, needs an inter vivos backstop to prevent the avoidance of the statute when this second purpose is being served.

If the deemed gift rule applies to our transaction, P is deemed to have made a gift to C equal to the value which would have been included in P's gross estate (without regard to Sections 2032 and 2032A) if P had died on that date. The estate tax contains a number of provisions designed to ease the liquidity problems caused by the imposition of an estate tax on a closely held family business; comparable provisions do not exist under the gift tax. Thus, the triggering of deemed gift treatment could result in the demise of a family business.

The most significant relief in the context of an estate is the benefit of the step-up in basis in estate assets.[27] This avoids capital gains tax on assets that must be sold to finance the estate tax liability. The gift tax liability must be financed by sales which result in capital gains tax, which must be financed by sales which result in capital gains tax, and so on. Section 303 permits an income-tax-free corporate redemption to pay estate tax, but no comparable provision exists for a redemption to pay gift tax. Section 6166 permits the payment of estate tax attributable to a closely held business in installments at a reduced interest rate, but no comparable installment provision exists for the payment of gift tax. Section 2032A permits the valuation of farmland and closely held business realty at its use value for federal estate tax purposes, but no comparable valuation provision exists for gift tax purposes.

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[23] 1987 Conference Agreement at 996.

[24] See, e. g., *Wallace v. United States*, 82-1 USTC ¶ 13,442 (D. C. Mass 1981); PLR 8723007 (February 18, 1987); PLR 8726005 (March 13, 1987).

[25] It may be the treatment of the preferred stock as consideration under this particular transaction that generated the apparent confusion discussed in note 17, supra.

[26] 1988 Tax Act, Sec. 3031(a).

Given the disadvantageous treatment of gifts, it was hoped that triggering the "deemed gift" rule would be difficult. However, it is relatively easy to trigger a deemed gift by any one of three different events.

First, the transferee's disposition of transferred property to a nonfamily member of the transferor will trigger a deemed gift. Under Section 2032A, the IRS has pursued a lengthy course of fruitless, purposeless litigation over whether a trust is a nonfamily member when extremely remote interests in a trust may potentially pass to nonfamily members.[28] It is not likely that this litigation would be repeated in this context. While the IRS perceives the family member test as an important limitation on the benefits of Section 2032A, the instant provision was enacted as a relief provision. Once appreciation passed outside the transferor's family, the transferor no longer would have to pay transfer tax on that appreciation. *Treasury should give guidance that a trust is a family member if the benefits of family members predominate.*

Second, the transferor's disposition of the retained interest (except to a spouse under circumstances discussed below) will trigger a deemed gift.

Finally, the transferee's return of the transferred property to the transferor will trigger a deemed gift.[29]

The possibility that a deemed gift would be triggered is enhanced by the adoption of a House bill provision in the 1988 Tax Bill.[30] It provides:

> Terminations, lapses, and other changes in any interest in property of the original transferor or original transferee shall be treated as transfers.

Another provision added by the 1988 Tax Bill lessens the probability:

> [No deemed gift shall occur] if the original transferor or the original transferee (as the case may be) retains a direct or indirect continuing interest in the property transferred in such transfer.[31]

The latter provision presents an important question as to whether it would apply if the disposition (or termination or lapse) results in the receipt of new continuing rights. The legislative history to the 1988 Tax Act answers this question positively.[32] In an example the transferor and transferee contribute their respective preferred and common to a new holding company. The interest in the holding company received in exchange postpones the deemed gift. *Treasury should define very broadly the circumstances under which this exception to the deemed gift rule operates —for example, the receipt of debt for the interest disposed of, the receipt of an option to repurchase or the receipt of an equity interest.* The application of this exception ought not to turn on the income tax treatment, taxable or nontaxable, of the exchange or sale.

The gift from P to C would result in a deemed gift of the common from P to C.

5. Spousal Freeze. P, from our prior example, instead visited a different lawyer who advised that all of the preferred be given to P's spouse, S, and that all of the remaining common be given to C.

The Unity Rule

Different advice, but any better? Although the deemed gift rule contains no exceptions for transfers of the retained interest by the original transferor, the "unity rule" contains an implicit exception for transfers to a spouse.

The unity rule in Section 2036(c)(3)(C) provides that an individual and that individual's spouse shall be treated as one person. The effect of this rule on deemed gifts is stated in the 1988 Conference Agreement:

> The conferees intend that spouses generally be treated as one if the retained interest in the enterprise is transferred to the spouse in a transaction which qualifies for the marital deduction (or the annual exclusion with respect to the spouse). For example, if a person transfers common stock

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[27] IRC Sec. 1014.

[28] *Est. of Davis IV v. Comm.*, CCH Dec. 43,105, 86 TC 1156 (1986); *Est. of Clinard v. Comm.*, CCH Dec. 43,106, 86 TC 1180 (1986); *Est. of Smoot v. United States*, 88-1 USTC ¶ 13,748 (C. D. Ill. 1987); *Est. of Pliske v. Comm.*, CCH Dec. 43,202(M), 51 TCM 1543 (1986).

[29] 1988 Tax Act, Sec. 3031(a)(1) amends IRC Sec. 2036(c)(4)(A)(ii) to read as follows:

> (ii) The original transferor transfers . . . to a person who is not a member of the original transferor's family . . . .

The 1988 House Bill had clearer language:

> . . . to a person who is not *the original transferor* or a member of the original transferor's family . . . .

The deletion of the italicized phrase must have occurred as a result of a view that the language was redundant. Senate Rept. No. 100-445 (August 3, 1988) reflects no substantive change. (This report is referred to herein as the 1988 Senate Report.)

[30] IRC Sec. 2036(c)(4)(D)(iv), as amended.

[31] IRC Sec. 2036(c)(4)(E), as amended.

[32] 1988 Senate Report at 525.

> to a child and preferred stock to a spouse, either during life or at death, section 2036(c) applies with respect to the transferee spouse, since the transfer of the preferred stock qualifies for the marital deduction (or the annual exclusion with respect to the spouse). Thus, the common stock is includible in the spouse's estate. The same result would obtain if the preferred stock is transferred to a trust in which a spouse has an interest if the spouse's interest in the trust qualifies for the marital deduction (or the annual exclusion with respect to the spouse).
>
> Spouses would not generally be treated as one if the retained interest is not transferred in a transaction qualifying for the marital deduction (or the annual exclusion with respect to the spouse). Thus, if a person transfers property to a trust in which a spouse has only an income interest, section 2036(c) would not cause the trust to be included in the spouse's estate if the transfer to the trust does not qualify for the marital deduction (or the annual exclusion with respect to the spouse).[33]

In this transaction, therefore, the transferred common would be included in S's estate. Conversely, a transfer to S which would not qualify for the marital deduction or annual exclusion *would* trigger a deemed gift from P to C.

The 1988 Conference Agreement does not specifically state whether the transfer to S relieves P of gross estate inclusion under Section 2036(c), but that appears the only analysis which would not substantially distort the application of Section 2036(c). If P predeceasing S resulted in inclusion in P's gross estate of the common stock, then at S's death two results would be possible: first, Section 2036(c) could require common stock inclusion, again resulting in double estate taxation of the same stock; or second, Section 2036(c) could exclude common stock from S's gross estate even though S continued to enjoy the benefits of the preferred. Conversely, if S predeceases P and Section 2036(c) could require common stock inclusion in P's estate, then P's estate will be doubly taxed.

The one rational approach consistent with the legislative history is to apply Section 2036(c) only to the spouse's estate in which the "retained interest" is included. *The Treasury should clarify this point immediately as interspousal gifts are common in family companies.*

The transaction illustrates the difficulty of applying this ubiquitous spousal income tax rule in the transfer tax context. Indeed, some commentators undoubtedly would suggest that its application in this context may be unconstitutional as the transferee spouse in whose estate the common is included never made a transfer of the common. Hopefully, its difficult application under this statute will discourage its further use in transfer tax statutes.

6. Gift of Minority Interest in Common. P owns all of the common in Corp. P gives 10 percent of the common to C. Corp has a value of $1,000,000, but P claims on the gift tax return that the gift to C has a value of only $80,000 due to a discount for lack of marketability and minority interest.

The Meaning of Disproportionate Appreciation

The 1987 Revenue Act applied to transfers of "property having a disproportionately large share of the potential appreciation in [the transferor's] interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise, then retention of the retained interest [is] . . . a retention of the enjoyment of the transferred property."[34] The 1988 Tax Act eliminated the requirement that the retained income or rights be disproportionate.[35]

Disproportionate appreciation is defined by the relationship between two ratios according to the 1988 House Report:[36]

$$\frac{\text{Potential Appreciation of Transferred Property}}{\text{Value of the Transferred Property}}$$

$$\frac{\text{Potential Appreciation of Retained Interest}}{\text{Value of Retained Interest}}$$

If the first ratio exceeds the second, then the disproportionate test is satisfied.

There are three fundamental problems with the House test for the determination of disproportionate appreciation.

The first fundamental problem is that the second ratio is not found in the statute. The statute refers not to the retained interest after the transfer, but the interest of the transferor in the enterprise prior to the transfer.[37] The statutory test focuses on how the transfer of certain property out of all of the existing interests in the enterprise carries a disproportionate share of appreciation when compared with the interests as a whole. This is an unwelcome focus for those who want to read out of the Code the requirement of a transfer of property.

The second fundamental problem is that the proposed test requires valuing the retained interests and transferred property. This contradicts the House Report's assertion elsewhere[38] that Section 2036(c) is needed *because of* the difficulty of valuing such interests. A valuation test is not needed to determine disproportionate appreciation if both the retained interests and the transferred property are stock interests. A valuation test is needed to apply Section 2036(c) only to retained interests which are not stock, such as debt. The necessary conclusion is that Section 2036(c) cannot be applied to such nonequity interests.

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[33] 1988 Conference Agreement at 75-76.

[34] IRC Sec. 2036(c)(1)(B).

[35] 1988 Tax Act, Sec. 3031(e).

[36] 1988 House Report at 423, n. 120.

[37] IRC Sec. 2036(c)(1)(B).

[38] 1988 House Report at 422-24.

The third fundamental problem is linked to the most difficult valuation issue. The test requires an impossibility: the prediction of the amount of appreciation, an impossible determination even in a publicly traded market such as the stock exchange.[39]

These three fundamental problems mean that the 1988 House test is useless and disproportionate appreciation will have to be determined solely by whether the transferred property potentially has a greater *right* to appreciation in the enterprise than the retained interest. Because preferred stock can satisfy the disproportionate appreciation test if the business declines in value and the common is wiped out, implicitly the legislative history conclusively presumes that the transferred property cannot depreciate in value, i. e., the enterprise appreciates.

Applying the House test to this transaction results in inclusion in P's estate. Certainly, if Corp is sold, P's fiduciary obligation as majority shareholder to C would mean that each would share proportionately in the purchase price. This means, of course, under the valuation analysis that property having a disproportionate share of appreciation has been transferred to C. (It also should be recognized that this is an unlikely result if the individual shares in the company are sold. It is certainly possible that the purchaser of individual blocks of shares would be willing to pay more proportionately for the control of the company than for a minority position).

Despite the apparent application of Section 2036(c) to the gift of minority stock, the 1988 House Report states:

> Thus, Section 2036(c) does not apply if the transferor retains an undivided interest in property, i. e., a fractional or percentage share of each and every interest in the property.[40]

The reason for the inconsistency in the 1988 House Report with its disproportionate test is the recognition of the compromise which resulted in the enactment of Section 2036(c). As discussed above, Section 2036(c) was enacted in exchange for the failure to enact a provision denying gift tax discounts to entirely family-owned businesses. History is more important, in this context, than statutory language or explanation.

7. Gift of Nonvoting Stock. P owns all of the voting and nonvoting common of Corp. Each class represents 50 percent of the value of Corp on liquidation. P gives all of the nonvoting common to C claiming a 5 percent discount for lack of vote.

*The Anti-*Byrum *Legislation*

The analysis as to whether the nonvoting common is included in P's gross estate under Section 2036(c) depends again on the disportionate appreciation test. If Corp is sold, then the nonvoting stock has a greater potential for appreciation. If only individual shares are sold, then it is more likely that the voting stock will appreciate faster than the nonvoting stock. However, unlike the previous transaction, there is no specific statement in the legislative history which excepts this transaction from the application of Section 2036(c). Nonetheless, there is an equally good historical reason that the transaction ought to be excepted.

After Congress considered the decision in the United States in the *Byrum*, the Congress enacted Section 2036(b), which prohibited the transfer of closely held stock while retaining the right to vote such stock. The legislative history to Section 2036(b) contained a specific exception for the gift of nonvoting stock while retaining voting stock which is adopted by the proposed regulations thereunder.[41] In the compromise resulting in the enactment of Section 2036(c), the continued effectiveness of Section 2036(b) was not at issue. This was not an oversight as the 1987 statute applied to transfers of property with disproportionate rights of appreciation and retention of voting *common* was inconsistent with this scheme. Accordingly, gross estate inclusion of gifted nonvoting common stock while voting common is retained ought to be tested under Section 2036(b) rather than under Section 2036(a). It ought not be held that Congress without any reference or expression of intention intended to overrule Section 2036(b). *Treasury should clarify the status of the law immediately to except a gift of nonvoting common stock while retaining common stock from the application of Section 2036(c).*

An even more important step in conjunction with this action would be for Treasury to reject the House's disproportionality test based on value as inconsistent with the statutory disproportionate test. Under the statutory test the gifted nonvoting common carried a right to appreciation proportionate to P's right to appreciation before the gift, but a disproportionate vote when compared to P's vote before the transfer. However, Section 2036(c) applies only to a transfer of property having disproportionate appreciation. Applying Section 2036(c) to the gift of nonvoting common stock when only common stock is retained would convert this section from a transfer tax on gifts which result in the transfer of *disproportionate appreciation* to a transfer tax on gifts which result in the *disproportionate retention of income or rights.* It is clear that the latter was not intended, as the 1988 Tax Act removed any reference to the requirement of disproportionate retention, requiring the sole test to be the transfer of disproportionate appreciation.[42]

The statutory test avoided the quicksand of valuing both the retained interest and transferred property and speculating as to the potential appreciation of each. Restoring the statutory test

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[39] The creator of this test ought to invest in stocks if he or she has such prescience.

[40] 1988 House Report at 423.

[41] Prop. Reg. § 20.2036-2(a).

[42] 1988 Tax Act, Sec. 3031(e).

(i. e., does the transferred property potentially have a greater *right* to appreciation?) is more consistent with the recognition that valuing such interests is a difficult endeavor. This approach would divorce the disproportionality test from the values taxpayers and the IRS place on the transferred property.

By returning to the statutory test, neither a gift of nonvoting common stock nor of discounted common stock is caught by the five-factor test. Under the House's value test, such transfers are caught or not caught simply as a matter of legislative or executive whim.

It is this willingness to have Section 2036(c) applied to all family investments, while excepting out those which, at a lowest common denominator, are nonabusive that frustrates practitioners and taxpayers. Admittedly, it is a more difficult task to establish a rational scheme which applies only to those transactions which are "abusive." Reinvigorating the statutory disproportionate rights test (and dumping the House's disproportionate value test) would be a simple step toward establishing that rational scheme.

B. Nonequity Business Transactions. *1. Creation of Nonequity Rights with Retention of Equity.* P and C each own 50 percent of the common stock of Corp. P loans $100,000 to Corp in exchange for a note at prime.

Application of the Disproportionate Appreciation to Nonequity Interests

Debt transactions generally are imagined to be within the scope of Section 2036(c), but it is difficult to fit debt within its statutory scheme. Clearly, Corp is a family enterprise and, in isolation, the transfer of cash to Corp increases the value of its common. This should be contrasted with an exchange of equity interests in a recapitalization where no enrichment of the corporation occurs. Equally clear is the retention of rights and income stream in the enterprise through the common stock which is retained. Thus, in this transaction four of the five factors are satisfied.

The uncertainty in applying Section 2036(c) to the transaction is the disproportionate appreciation test.[43] Under the statute, no portion of the cash transferred to Corp is a part of P's interest in the enterprise prior to the transfer. Thus, the contribution cannot be said to carry a disproportionate right to appreciation of P's interests in the enterprise.

The House valuation test creates the possibility that Section 2036(c) would apply. The denominator of the first ratio under the House test is easy to determine: $50,000 (one-half of the property transferred to the corporation) is the value of the property transferred. The numerator, its potential appreciation, is presumably determinable.

The denominator of the second ratio is problematic. The House test, by focusing on the "interests retained by P" rather than on "P's interests in the enterprise prior to transfer," allows the note potentially to be considered as part of the "retained interests" in the enterprise, contradicting the statutory language. Still, under the House test, if the note is not a retained interest, then no disproportionate appreciation has been shifted to C. Conversely, if the note is a retained interest, then a greater share of appreciation of Corp has been shifted to C as the note potentially will not appreciate in value. Thus, the application of Section 2036(c) to this transaction turns on an adoption of the House test *and* the treatment of nonequity rights as a retained interest.

Can Nonequity Interests Be Retained Interests?

The 1987 Conference Agreement defines rights as "voting rights, conversion rights, liquidation rights, warrants and options and other rights of value" thereby suggesting that the term "rights" is limited to equity or ownership rights.[44] Thus, the note received by P in the transaction is not a retained interest, unless the interest payments on the note are an interest in the income stream of Corp. Nothing in the statute or legislative history suggests that interest payments should have such a status. Interest payments, unlike dividends, must be paid whether Corp has sufficient income or not. A similar analysis ought to be applied to all rights as a creditor whether by reason of a loan, provision of services or property or for any other reason. Extending Section 2036(c) to nonequity interests is unsupported by the statute or legislative history.[45]

Transfer for Consideration

If one accepts that the House disproportionality test has displaced the statutory test and that "retained interests" can include nonequity interests, which one ought not accept, then the transfer still is for "full value." Certainly the cash has a value equal to the note received in exchange. Because the note is consideration for the transfer, the 1988 Tax Act provides that the value of the transferred property is fully excluded, unless this consideration is traceable to P.[46] Here the note depends solely on the future success of the enterprise. Under such circumstances, how should this future performance be traced to P or C?

Two tests are possible. First, the derivation of the ownership of Corp by C could determine whether the note is traceable to P. If C received his common from P, then under this test no bona fide sale would exist. Second, the derivation of the common could be irrelevant, the only relevant factor being ownership at the time a commitment of future earnings of Corp is made. *At the very least, Treasury should adopt this latter rule.*

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[43] IRC Sec. 2036(a)(1)(B).

[44] 1987 Conference Agreement at 996.

[45] As discussed below, the 1988 Tax Act does create "safe harbors" which will exempt clearly nonabusive nonownership transactions without clarifying whether Section 2036(c), as enacted, applies to such transactions.

[46] 1988 Tax Act, Sec. 3031(g).

Policy Issue

If the statute is an insufficient reason for excluding debt from the scope of Section 2036(c), a good policy reason exists. Because Section 7872 sets forth the appropriate interest rate and terms which must be followed to avoid a gift, there is no good policy reason to further apply Section 2036(c) to the transaction. If the requirements of Section 7872 are not met, the debt would have a value less than the property transferred to the enterprise and a gift would result.

2. Complete Sale of Stock. P owns all of the stock in Corp, has a 20-year employment agreement and owns the corporate plant which P leases to Corp. Corp redeems one-half of P's stock, and P sells the other one-half to C.

Nonenterprise Interests

If both Corp and C borrow the money to pay P for P's stock, and Corp also buys out P's contract and the purchase of the plant, then P clearly would retain no interest in the enterprise. Accordingly, Section 2036(c) would not apply to the transaction. If Corp issues a note to P or P retains the lease or employment agreement, then the preceding analysis is controlling as to whether P has any "retained interest" from these nonequity rights.

This transaction also raises a new issue as to whether a personal note from C can be considered a "retained interest" in the enterprise. If the note from C is completely personal, it is difficult to imagine that any retained interest in the enterprise exists. P simply has no right to income or any other right in the enterprise. P's rights are solely against C.

It may be problematic, however, for P to retain a security interest in either the assets or equity of Corp. P's rights as secured creditor might be considered "rights" in the enterprise. In this transaction, it is particularly important that P retain a security interest in the stock or the assets of Corp; otherwise P is disadvantaged as compared to other creditors of C. *Treasury should remove this potential discrimination by immediately giving notice that the term "rights" does not include rights which are solely those of a creditor.*

Statutory Safe Harbors

The 1988 Tax Act offers an alternative to business owners who consider the technical analysis under Section 2036(c) the legal equivalent of "counting dancing fairies on the head of the pin." Statutory safe harbors were included in the 1988 Tax Act to permit certainty in business transactions. While some may suggest that the mere creation of statutory safe harbors might lead to the conclusion that the 1987 Revenue Act was intended to apply to nonequity interests, there is simply no support for that proposition.

Indeed, the purpose of the statutory safe harbors was to obviate the need to rationalize the statute and its legislative history. It is simpler to presume that Section 2036(c) might apply and then to except clearly nonabusive transactions from its application, than it is to provide legal standards. Moreover, establishing legal standards requires Congress to face difficult policy issues. The failure to establish standards, however, puts Congress and Treasury in the business of selling "cookie-cutter" estate and business plans.

The qualified debt exception is of particular importance because it obviates the necessity of borrowing from an outside third party. The business owner is permitted to receive or retain "qualified debt" which meets this statutory safe harbor:

> (1) The indebtedness
>
> (a) unconditionally requires the payment of money in one or more fixed payments on specified dates, and
>
> (b) has a fixed maturity date of not more than 15 years (or not more than 30 years in the case of a mortgage).
>
> (2) Only interest and principal may be paid under such indebtedness, and the interest must be determined—
>
> (a) at a fixed rate or
>
> (b) at a rate which bears a fixed relationship to a specified market interest rate.
>
> (3) The interest payment dates must be fixed.
>
> (4) The indebtedness must not be by its terms subordinated to the claims of general creditors; however, it can be subordinated to the claims of particular creditors.
>
> (5) Such indebtedness, unless in default as to interest or principal, may not grant voting rights to the lender or place any limitation on the exercise of voting rights by others.
>
> (6) Such debt must *not* be directly or indirectly convertible into an interest in the enterprise (other than qualified debt) or not otherwise grant a right to acquire such interest.[47]

A loan of cash to the enterprise for its normal business needs is not required to have a fixed maturity date or specified dates for principal repayment. In other words, such a loan can be on demand.

Two important points should be noted regarding the statutory safe harbor for debt. First, the interest rate on the debt need not meet the Section 7872 requirements. This means that the discounted value of the debt need not equal the amount loaned. Under these circumstances, Section 7872 will control the gift tax aspects of the transfer, but Section 2036(c) will not result in gross estate inclusion. Second, the effect of a security interest in the enterprise assets or equity is uncertain. Rather, the statute seems to focus on a *lack* of security by prohibiting qualified debt from being subordinated to the claims of general creditors. It is troubling, nonetheless, that this very common situation is not specifically addressed by the statutory safe harbor. *This omission ought to be cured by a notice from Treasury.*

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[47] New IRC Sec. 2036(c)(7)(C).

The statute also provides safe harbors for employment arrangements and agreements for the sale or lease of property: [48]

> (1) The agreement must be at arm's length for fair market value;
>
> (2) The agreement must not otherwise "involve any change in interests in the enterprise";
>
> (3) In the case of a compensation agreement, the term of the agreement cannot extend past 3 years. For purposes of this test, any option the service provider has to unilaterally extend the agreement is counted in determining the term; [49] and
>
> (4) No payment under the agreement may be determined, in whole or in part, "by reference to gross receipts, income, profits or similar items of the enterprise." [50]

As long as an agreement satisfies the statutory safe harbor, it will not result in gross estate inclusion under Section 2036(c).

One troubling aspect of these safe harbors is the cryptic requirement that the agreement "does not otherwise involve any change in interests in the enterprise." The legislative history suggests that it merely precludes the issuance of stock, stock options or similar equity-based compensation arrangements, such as, perhaps, an employee stock ownership plan.[51] Concern exists, however, that this might preclude, for example, the adoption of an employment agreement or lease arrangement at the same time as the sale of stock or other change in the equity interest in the enterprise. *Treasury should clarify the meaning of this requirement immediately.*

Another troubling aspect of these safe harbors is the requirement of fair market value. The 1988 legislative history makes clear that one of the reasons for enacting Section 2036(c) was the difficulty in establishing fair market value for gifts of enterprise interests. These safe harbors, for the most part, present even more difficult valuation issues.

This problem is particularly acute with respect to the safe harbor for buy-sells and options which requires a fair market value price determined at the time of exercise.[52] If the buy-sell agreement applies to all shares equally, then a gift of stock subject to the buy-sell ought not to result in a transfer of property having disproportionate appreciation. *Treasury should provide guidance that a cross buy-sell and cross-option arrangement which treats transferor and transferee identically is not subject to Section 2036(c).*

C. Grandfathered Freezes. In 1985, P recapitalized his wholly owned Corp. P gave away the common after the recapitalization to C. The preferred stock which P retained had a 10 percent noncumulative dividend which has never been paid and a right to convert to common at fair market value. P and C are now considering whether to convert the preferred back to common and make an S election, keep the freeze in place or redeem the preferred for a note.

The Effective Date Clarification

Section 2036(c) applies only to transfers made after December 17, 1987. Accordingly, pre-December 18, 1987, freezes are grandfathered. It generally was presumed that the IRS would attempt to apply its theory that a gift occurred on the passing of dividends on preferred stock or the failure to convert preferred to common so as to create a transfer after December 17, 1987, to which Section 2036(c), partially or completely, might be applied.[53]

The 1988 Tax Act clarifies that a transfer subsequent to December 17, 1987, could not occur with respect to property transferred on or before December 17, 1987, by reason of any failure to exercise a right of conversion, any failure to pay dividends or any other failure to exercise other rights specified in regulations, provided such rights were in existence on that date.[54] Thus, P can continue the freeze without paying a dividend and not run afoul of Section 2036(c). The IRS, however, is free to apply its gift theories to claim a gift tax or to utilize Section 2036(a) to claim an estate tax.

Another problem with leaving the freeze in place is that any transfer which occurs after December 17, 1987, would be caught by Section 2036(c). Thus, care will have to be exercised to see that no additional property is transferred to the common shareholders. This prohibition, however, would not seem to preclude transfers of preferred stock as the property transferred after December 17, 1987, must have a disproportionately large share of the potential appreciation. A more likely problem is that a right will be created after December 17, 1987, which fails to fall within a statutory safe harbor.

If Section 2036(c) does not apply because a freeze is grandfathered, no deemed gift can result if the freeze is undone for purposes of making the S election. Section 2036(c)(4)(D)(iii) measures the amount of the deemed gift by determining the hypothetical gross estate inclusion under Section 2036(c), assuming for such purposes that the transferor had died. Because the grandfathered freeze could not result in any Section 2036(c) inclusion, no deemed gift could occur.

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[48] New IRC Sec. 2036(c)(7)(A)(ii) and (B).

[49] New IRC Sec. 2036(c)(7)(B)(i).

[50] New IRC Sec. 2036(c)(7)(B)(ii).

[51] 1988 House Report at 426.

[52] New IRC Sec. 2036(c)(7)(A)(iii).

[53] See citations at note 24, above.

[54] 1988 Tax Act, Sec. 3031(h)(5).

The Correction Period

The 1988 Tax Act also creates an additional safe harbor period between December 17, 1987 and January 1, 1990. Section 2036(c) would not apply under the following circumstances:

> (4) CORRECTION PERIOD.—If section 2036 (c)(1) of the 1986 Code would (but for this paragraph) apply to any interest arising from a transaction entered into during the period beginning after December 17, 1987, and ending before January 1, 1990, such section shall not apply to such interest if—
>
> (A) during such period, such actions are taken as are necessary to have such section 2036(c)(1) not apply to such transaction (and any such interest), or
>
> (B) the original transferor and his spouse on January 1, 1990 (or, if earlier, the date of the original transferor's death), does not hold any interest in the enterprise involved.[55]

The meaning of "such actions are taken as are necessary to have such section 2036(c)(1) not apply to such transaction" simply is unclear. The 1988 Conference Agreement states that this adopts the Senate provision which was explained as permitting taxpayers to bring their transactions within the statutory safe harbors.[56] It is not clear that the provision is so limited by the statute, and it might be possible to simply undo a transaction without triggering the deemed gift rules or resulting in Section 2036(c) inclusion. It is important to remember that "undoing" the transaction is not exempted from other transfer tax and income tax provisions.

This would seem to be an aggressive position, however, as the second part of the test requires that the transferor and the spouse completely dispose of all interests in the enterprise to fall within its grandfathering. If (A) can be read as broadly as suggested, then (B) is meaningless. Another apparent omission is that the safe harbor exception in (A) appears to apply even if the transferor or the spouse dies prior to January 1, 1990. Thus, post-death actions taken to avail oneself of the statutory safe harbor could be retroactive for tax purposes. This is not true under (B).

D. New Enterprises. P purchases a 10-year income interest in farmland, and C purchases the remainder after the term. The amounts which P and C pay are determined under the 10 percent gift tax valuation tables in the regulations.

1. Joint Purchases. On its face, Section 2036(c), as enacted, did not apply to joint purchases or other types of new enterprises.[57] The 1988 Tax Act made no statutory change; however, the 1988 House Bill had proposed a change in the substantial interest test to apply the test *before and after* the transfer.[58] The House report stated that with that amendment, Section 2036(c) would apply to joint purchases and, implicitly, to other new enterprises.[59]

This modification was necessary because at the time of the "transfer" neither P nor C had any interest in any enterprise. Thus, the substantial interest test would not be satisfied. The House report contended that if you could apply the test after the transfer, then the asset which P and C owned would satisfy the substantial interest test.[60]

Failure to include the proposed change in the substantial interest test may be construed as a congressional intention not to expand Section 2036(c) to include new enterprises and joint purchases. Nonetheless, no statutory change was enacted which would limit or expand the scope of Section 2036(c) with respect to new enterprises or joint purchases.

Thus, the issue remains as to whether Section 2036(c), as enacted in 1987, applies to enterprises which satisfy the substantial interest test prior to the transfer. This can occur because old enterprise interests are transferred to the new enterprise. The answer to this question turns solely on whether a transfer is made when a person purchases or exchanges one interest for another at fair market value, so that no one is enriched or receives property as a result of the purchase or exchange. This is precisely the issue which was analyzed above in the recapitalization transaction. In the case of a new enterprise, however, there is an even stronger position against finding a transfer because no transfer is made to the enterprise itself. This is a distinction without much meaning, perhaps, but still a distinction. It is unlikely, therefore, that Section 2036(c) catches new enterprises, even if the substantial interest test is satisfied.

Nonetheless, the conference agreement does contain a troubling statement: "The conferees understand, however, that Section 2036(c) applies if a parent transfers an existing enterprise or asset from such enterprise to another enterprise in which a child owns a disproportionately large share of potential appreciation and in which the parent retains an income interest or other rights."[61] The simple answer is that the conferees were misinformed. However, another possible explanation is that holding companies which do not actually carry on the enterprise should be disregarded so that the equity rights in the holding company are attributed to the operating companies. In this way, a transfer to a holding company is just a restructuring of the rights in the enterprise itself.

This analysis is consistent with the conclusion that Section 2036(c) does not apply to new enterprises, while allowing the conferees' opinion to be adopted as part of the law. It is important to note, however, that in other situations where holding companies are to be disregarded, such as under Section 6166, an actual statutory provision has been adopted to reach that result. *Treasury should adopt this position immediately if it wishes to maintain the Conferees' conclusion.*

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[55] 1988 Tax Act, Sec. 3031(h)(4).

[56] 1988 Conference Agreement at 73.

[57] Purchases of interests from third parties do not present the same valuation issues as gifts. Thus, as a matter of policy ought not apply to new enterprises.

[58] 1988 House Bill, Sec. 4(A).

[59] 1988 House Report at 424.

[60] Id.

[61] 1988 Conference Agreement at 74.

2. Loan for Business Investment. C desires to start a new business, but lacks capital and borrowing power to do so. P loans C the money to start the business.

Unless P takes a security interest in the new business, it is difficult to see how P has the required interest in C's enterprise. Despite the probability that Section 2036(c) would not apply to such a transaction, a special statutory safe harbor was created for "qualified start-up debt," meaning indebtedness meeting the following tests:

> (1) The indebtedness unconditionally requires the payment of a sum certain in money;
>
> (2) The indebtedness was received in exchange for cash to be used in an enterprise involving the active conduct of a trade or business;
>
> (3) The lender has not at any time transferred to the enterprise property, including goodwill, customers or business opportunities;
>
> (4) The lender has not held any interest as an officer, director or employee in the enterprise;
>
> (5) The transferee is actively managing the enterprise within the meaning of Section 2032A(e)(12);
>
> (6) The indebtedness does not grant voting rights except on default; and
>
> (7) Such indebtedness is not convertible into any other interest in the enterprise (other than qualified debt) nor grants any right to acquire such interest.[62]

These statutory requirements make it clear that the qualified start-up debt exception is to apply only when the enterprise is clearly the transferee's. In fact these requirements are so rigorous that Section 2036(c) could apply to a parent who sends his child to college and then gives the child a used typewriter at graduation on which to write the Great American Novel. There is simply no reason to believe that Section 2036(c) was intended to or can be applied under these circumstances.

3. Loan for Personal Expenditure. C wishes to buy a new house. P loans C the money to purchase the new house and takes back a mortgage. To make the mortgage payments affordable to C, who also just became a parent, P stretches principal payments out for 35 years.

The 1987 Conference Agreement defined enterprise very broadly, including "a business or other property which may produce income or gain." [63] This definition would seem to encompass even assets such as personal residences, provided the possibility of appreciation exists. The only exception to the enterprise definition would seem to be amounts used for consumption purposes and perhaps bare contract rights.

Assuming that the definition of enterprise is met and that the retention of a security interest is a sufficient retained interest in the enterprise, then Section 2036(c) would seem to require a deemed gift each time the child pays back a portion of the principal of the mortgage.[64] This presumably would be based on the proportionate part of the mortgage principal paid each month and the value of the house each month.

While it would be possible to restructure the mortgage to meet the qualified debt exception, it is highly unlikely that an individual would consult a highly paid tax specialist when entering into this transaction. Although the requirements for qualified start-up debt are less rigorous than for qualified debt (including the absence of a maturity date requirement), the former exception applies only to a loan to start an active trade or business, not to the purchase of a residence.

E. Impact of Section 2036(c) on Estate Planning Devices. *1. Traditional Trust.* P dies, leaving a will which directs that all of his property be retained in trust during P's spouse's (S) lifetime, paying S all of the income from the trust property and needed principal. On S's death, the property is to distribute to C. P's executor will make a qualified terminable interest property election such that the minimum marital deduction which will produce no estate tax is elected. Accordingly, a fraction of the appreciation in the trust will escape estate tax.

It was widely assumed when Section 2036(c) was first enacted that it would not apply to traditional trusts. The notion always has existed that trusts are for the conservation and protection of property and are not to be operated as a business. Under a narrow interpretation of the term "enterprise," therefore, a trust would not have been considered an enterprise. The 1987 Conference Agreement, with its broad definition of enterprise, should have disabused practitioners of this notion; however, there was no legislative history or statutory language suggesting that this broad enterprise definition was intended to encompass traditional trust arrangements.

The extent to which Section 2036(c) could be applied to traditional trusts was reduced substantially when the 1988 Tax Act failed to extend Section 2036(c) to new enterprises. The creation of a trust funded with cash or other assets, therefore, should not result in the application of Section 2036(c) to the trust. Nonetheless, Section 2036(c) could still apply to the extent the trust is funded with interests in an existing enterprise or to the extent additional amounts are added to an existing trust.

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[62] New IRC Sec. 2036(c)(7)(D)(ii).

[63] 1987 Conference Agreement at 996.

[64] This conclusion is based on the 1988 House Report which states (at 421) that the provisions deferring a deemed gift until retained interests are completely disposed of does not apply where proportionality is restored. This limitation on the application of the continuing interest rule is not expressly part of the statute.

After practitioners came to the realization that traditional estate planning trusts potentially were enterprises for purposes of Section 2036(c), the spectre of inclusion of a "credit shelter" trust[65] in the surviving spouse's estate was raised.

This analysis relied on the unity rule (described above), which can be read as treating the creation of an income interest in one spouse as the equivalent of income retention by the other spouse. In the example, P transfers an income interest to S by will while C potentially receives a disproportionate share of appreciation because of the exclusion of a fraction of the appreciation from S's gross estate.

Because eliminating credit shelter trusts seemed too drastic a step even for the 1988 Tax Act, it was determined that the unity rule should be limited to interests created in the spouse which qualified for the marital deduction or the annual exclusion. Interests of the spouse in the credit shelter trust obviously qualify for neither. This solution generally cures the problem of inclusion of the credit shelter trust in the surviving spouse's gross estate.

In our example, however, S does receive an interest (which is deemed to be retained by P) qualifying for the marital deduction. If you value S's income interest in the entire trust and in the nonmarital portion and compare those values with the potential appreciation in each part, depending on the relative sizes of the two portions, indeed the entire trust might be includible in S's estate. Obviously, this result was not intended by Congress as it specifically recommended these rules in the context of excluding the credit shelter trust from Section 2036(c). *Accordingly, Treasury should immediately give notice that for purposes of Section 2036(c), a trust which has a marital deduction component and a nonmarital deduction component will be considered as separate for purposes of the unity rule.*

2. Irrevocable Insurance Trust. P sets up an irrevocable trust with S and C each having the annual power to withdraw up to $5,000 of gifts made to the trust. The trustee invests in a life insurance policy on the life of P. P continues to make annual gifts to the trust to fund premium payments. After P's death the trust continues for the life of S paying S all income and then distributes to C on S's death.

The creation of the trust ought to be excepted from the application of Section 2036(c) as a new enterprise.[66] After its creation, however, the trust could be considered an enterprise in its own right. Accordingly, the annual exclusion gifts could be considered transfers to an existing enterprise which would be caught if P retained an interest in the trust. That retention could be based on S's interests in the trust if the unity rule applied.

The annual gifts from P to S qualify for the annual exclusion. Thus, the creation of S's interest in the trust is treated as an interest retained by S, and the transfers to C from P are treated as transferred by S. This means that Section 2036(c) will result in inclusion in S's estate of that portion of the trust attributable to the lapse of S's power of withdrawal.

It is unclear whether the reference to "annual exclusion" was specifically directed at *Crummey* trusts or merely reflected a technical concern that a transfer to a marital deduction trust having mandatory income results in a portion of the trust qualifying for the annual exclusion rather than the marital deduction. There are specific references to insurance trusts in both the House and Senate Reports, but their impact is unclear.[67]

In any event, it appears that a nonmarital interest in the trust created in S after P's death would not result in inclusion in S's estate.

3. Grantor Retained Income Trust. P establishes a grantor retained income trust (GRIT), in which P retains the income for five years, a general power of appointment over principal if P dies prior to that date and a reversion if C dies prior to that date. If P and C both survive the five years, then C will receive the corpus. P discounts the gift by the actuarial value of P's retained interests.

If the GRIT is funded with cash, then Section 2036(c) should not catch the GRIT by reason of the "new enterprise" exception. A different result could be reached if interests in an existing enterprise are transferred to the GRIT. If the substantial interest test is satisfied in this way, then the income retained by the grantor is the retention of an income stream from the enterprise. That income stream retention is excepted from Section 2036(c) under the following circumstances:

(1) The amounts must be determined solely by reference to the income from property held in trust;

(2) The right to income may not extend past 10 years;

(3) The income right must be held by the grantor of the trust; and

(4) The grantor cannot be trustee of the trust.[68]

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[65] Sometimes called nonmarital trust, trust B or family trust.

[66] The one possible argument to the contrary is that the insurance policy is an "enterprise." The broad definition of enterprise certainly makes that a possibility, but under such an analysis any account or other segregated investment asset could be considered an enterprise. Under such a test, only interests in publicly traded companies or cash would not be an enterprise.

[67] 1988 Senate Report at 531; 1988 House Report at 428.

[68] 1988 Tax Act, Sec. 3031(b), adding new IRC Sec. 2036(c)(6).

It should be irrelevant that P retained a general power of appointment or reversionary interest as neither of those interests are an interest in the income stream of the enterprise. Such interests are not "rights" because they do not meet the definition of rights in the 1987 Conference Agreement.[69] Section 2036(c) should not catch the GRIT solely from the retention of such interests; however, caution would dictate that the safe harbor be strictly followed.

If a GRIT is created for longer than 10 years or some other statutory safe harbor requirement is not met, then the 1988 House Report would suggest that termination of the grantor's income interest would result in a deemed gift at the full fair market value of the property passing to C at that time.[70] Calling the ripening of a remainder interest into a fee "a termination or lapse" ignores traditional property law concepts. However, the statutory language seems sufficiently broad to reach the Committee Report's result.

F. Computational Exercises. The preceding discussion involves, for the most part, deciding on the preliminary question of whether Section 2036(c) catches the hypothetical transactions. The following discussion involves the uncertainties which arise with respect to transactions which Section 2036(c) clearly catches. Without resolving these uncertainties, it is impossible to report properly transactions that are clearly within the scope of Section 2036(c).

1. The Proportionality Rule—Transferred Property. P owns 100 percent of the common and 100 percent of the preferred in Corp. P gives 80 percent of the common and 20 percent of the preferred.

This is an easy transaction only because it is analyzed in the 1987 Conference Agreement.[71] The legislative history concludes that only 60 percent of the common is includible in P's gross estate. This is a logically satisfying result, but difficult to arrive at under the literal statutory language, because the statute refers to inclusion of the transferred property and not a *portion* of the transferred property.[72]

Nonetheless, it is not difficult to interpret Section 2036(c) as permitting the severance of a gift into two portions—a proportionate portion and a disproportionate portion—permitting the transfer of the proportionate portion while catching the disproportionate portion. The Conference Agreement concurs:

> If a share of appreciation borne by the transferred property is disproportionately large, but only with respect to part of the transferred property, only that part of the transferred property is included in the estate.[73]

The proportionality rule is a necessary corollary to the disproportionate appreciation test. Thus, it is influenced by whether the statutory test for disproportionate appreciation is based on rights, as the statute implies, or value, as the 1988 House Report implies.

If the statutory test is followed, then the transferred property must include rights which match up precisely *with the rights of the transferor* prior to the transfer. This is not the same as full proportionality in all of the corporate rights, a requirement which would be inconsistent with Section 2036(c)'s statutory language which looks to the transferor's interest in the enterprise prior to the transfer to determine disproportionality.

On the other hand, if the House test is used to test for disproportionate appreciation by comparing values, then conceptually a portion of the transferred property should nearly always have proportionate appreciation. From the two ratios of the House test, it must be possible to solve for an unknown portion, by value, of the transferred property that, when compared with its potential appreciation, has the same ratio as the potential appreciation of the retained interest to the value of the retained interest. This unknown portion of the transferred property should be excluded from P's gross estate. The House test assumes that the four components of the ratio are known (or determinable). It follows logically, therefore, that the solution for the unknown portion is no more difficult to derive than the ratios for determining disproportionality.

2. The Proportionality Rule—Retained Interests. P owns all of the common and preferred of Corp. P gives 50 percent of the common to an irrevocable trust (not qualifying for the marital deduction or annual exclusion). P desires to make an additional gift of 50 percent of preferred to the trust.

Before the 1988 Tax Act repealed the requirement of disproportionate retention of income or rights,[74] it was clear that P's "retained interests" in this transaction was the 50 percent preferred (containing disproportionate income and rights) corresponding to the gift of 50 percent of common (containing disproportionate appreciation).

In this transaction the initial gift of 50 percent of the common while retaining 100 percent of the preferred was caught by Section 2036(c). Accordingly, the later gift of preferred necessarily triggered the deemed gift rule. On its face, Section 2036(c) would appear to treat only a portion[75] of the transferred common as a deemed gift, as only 50 percent of P's preferred (and even less of P's total stock)[76] was transferred.

Because proportionality of ownership in Corp is restored by the transfer, logically the result must be that the full value of C's common is a deemed gift. In order to reach this particular result under the statute, a proportionality rule must be applied to P's holding of 100 percent of preferred and 50 percent of common so that 50 percent of the retained preferred is matched with the transferred 50 percent of common. After this use of the proportionality rule, then the transfer of 50 percent of the retained preferred can be considered a transfer of 100 percent of the "retained interest" under Section 2036(c).

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[69] 1987 Conference Agreement at 996.

[70] 1988 House Report at 420.

[71] 1987 Conference Agreement at 996.

[72] IRC Sec. 2036(c)(1)(B).

[73] 1987 Conference Agreement at 996.

[74] 1988 Tax Act, Sec. 3031(e).

[75] 1988 Tax Act, Sec. 3031(a)(1).

[76] Apparently requiring a valuation approach to determine the portion.

The inevitable conclusion is that the repeal of the disproportionality retention requirement was not intended to preclude the use of the proportionality rule in determining P's "retained interest." Rather, the repeal was intended to establish that only *one* test for disproportionality existed and the other proportionality rules are corollaries to that test. *It is submitted that unless Treasury clarifies this analysis taxpayers (and probably the courts and IRS) will calculate the deemed gift incorrectly under less pristine facts.*

A second implicit rule is required to reach the result in this example. The first transfer of P's preferred must be treated as a disposition of P's retained interest for purposes of Section 2036(c). It is likely that a similar rule would be applied whether the preferred was transferred to C (as in the instant transaction) or to someone else. It also is likely that a similar rule would be applied to a disposition by C of common; however, if C owned common prior to the gift a tracing rule would seem more appropriate. *Treasury must set forth appropriate ordering rules immediately.*

3. Successive Transfers. P owns all of the common and preferred of Corp. P gifts 25 percent of the preferred to a new irrevocable trust (Trust) for the benefit of C and C's descendants. Later in a separate transaction, P gifts 50 percent of the common to C's children (G). Finally, in a separate transaction, P wants to gift to C sufficient common and preferred to trigger a deemed gift and remove any future application of Section 2036(c) in P's estate. Only if absolutely necessary does P want to give preferred to G.

The initial transfer of preferred to Trust would not be caught by Section 2036(c) as the gifted preferred would not have disproportionate rights to appreciation. While preferred can appreciate more than common under a valuation based test for disproportionate appreciation, preferred does not have a disproportionate right to appreciation in the enterprise as the statute appears to require. There is no statutory support to "pull back" prior enterprise transfers, whether grandfathered or whether of common or preferred.

The gift of 50 percent of common to G, is caught by Section 2036(c). P's interests in the enterprise prior to this gift were 75 percent of preferred and 100 percent of common. As discussed in the previous example, the proportionality rule treats as "retained interests" that portion of the retained stock which when combined with the transferred common would reflect the proportion of appreciation in P's interest that existed prior to the transfer. This ratio was 3 percent of preferred to 4 percent of common. Thus, P's "retained interests" resulting from this transfer was ownership of 37½ percent of preferred.[77]

P's gift of 37½ percent of preferred in Corp to C, therefore, ought to trigger a deemed gift by P to G of gifted common. After that transfer P would have 37½ percent of preferred and 50 percent of common of Corp; C could be given common without Section 2036(c) catching the gift if C was given at least 3 percent of preferred for each 4 percent of common to reflect this ratio of preferred to common.[78] If P made the gift to C prior to the preferred stock gift, P must gift at least 6 percent preferred to each 4 percent common.[79] This makes the timing of the preferred gift to C crucial. *Treasury ought to consider excluding "retained interests"*[80] *from P's holdings in the enterprise to avoid this timing problem.*

4. Farmland Freeze. P owns 1000 acres of farmland worth $3,500,000. P transfers to C 100 acres of farmland worth $350,000. As part of the same transaction, P and C immediately form a partnership of the two farms, with P receiving frozen, high fixed return units and C receiving growth units. Both P and C receive units having a present value equal to the value of farmland each contributed to the partnership. When P dies four years later, the initial value of $3,500,000 for the partnership has declined to $1,500,000.

Inclusion in Gross Estate

This is not an example to illustrate that Section 2036(c) applies to partnerships as well as corporations, but it clearly does. Partnership units represent *ownership* rights, not *creditor* rights. Rather, this example illustrates that Section 2036(c) can have a beneficial effect.

The five-factor test for application of Section 2036(c) is satisfied. Although the growth interests actually declined in value, the disproportionate test is satisfied by the potential appreciation in the growth units when the gift was made. If the five-factor test is satisfied, then the value of the transferred units is included in P's gross estate at its present fair market value. This value had declined from $350,000 to zero.

Although an initial gift of $350,000 had been made, it is not an adjusted taxable gift by reason of Section 2001(b).[81] Thus, the value of the gift is not added to the taxable estate in determining P's estate tax. Section 2036(c), therefore, results in a reduction of P's estate tax.

5. The Consideration Exclusion. P owns all of the common and preferred of Corp, with each class valued at $5,000,000. P sells the common to S for $5,000,000. S has financed the purchase at a bank, and the loan is not traceable to P.

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[77] ¾ × 50%.

[78] It is assumed that no prior gifts, of either common or preferred, are pulled back for purposes of this determination.

[79] The ratio prior to the transfer was 75 percent of preferred to 50 percent of common.

[80] The 37½ percent preferred.

[81] This presumes that the adjusted taxable gift is traceable to the growth units of C. Unless that were the case, the new enterprise exception under Section 2036(c) would apply.

New Section 2036(c)(2)(B) provides as follows:[82]

> (B) TREATMENT OF CONSIDERATION.—
>
> (i) IN GENERAL.—In the case of a transfer described in paragraph (1), if—
>
> (I) a member of the transferor's family provides consideration in money or money's worth for such member's interest in the enterprise, and
>
> (II) it is established to the satisfaction of the Secretary that such consideration originally belonged to such member and was never received or acquired (directly or indirectly) by such member from the transferor for less than full and adequate consideration in money or money's worth,
>
> paragraph (1) shall not apply to the applicable fraction of the portion of the enterprise which would (but for this subparagraph) have been included in the gross estate of the transferor by reason of this subsection (determined without regard to any reduction under paragraph (5) for the value of the retained interest).
>
> (ii) APPLICABLE FRACTION.—For purposes of clause (i), the applicable fraction is a fraction:
>
> (I) the numerator of which is the amount of the consideration referred to in clause (i), and
>
> (II) the denominator of which is the value of the portion referred to in clause (i) immediately after the transfer described in paragraph (1).

Under the statute, the numerator of the applicable fraction is $5,000,000 (the consideration paid by C) and the denominator is $5,000,000 (the common includible in P's estate under new Section 2036(c), but for the consideration offset under Section 2036(c)(2)(B) or under Section 2036(c)(5)). Because the applicable fraction is 100 percent (1 over 1), no portion of the common is included in P's estate.[83]

6. The Tax Recovery Rule (and the GST Tax). P owns all of the common and preferred of Corp. P gives the preferred to an estate trust for S, P's spouse, and the common to G, P's grandchild. The trust pays S needed income and principal and the balance distributes to S's estate. P and S divorce and S is estranged from G, who is not S's descendant. S's will exercises all rights of recovery.

Under the unity rule, the value of G's common is included in S's gross estate despite the severed family connections. The 1988 Tax Act added a new Section 2207B to the Code, which provides S's estate a proportionate right of recovery against G for estate tax attributable to the common included in S's estate.[84] This proportionate right of recovery means that G will benefit from S's unified credit and lower estate tax brackets.[85]

The more difficult question concerns who bears the generation-skipping transfer (GST) tax attributable to the transaction. The original gift to G by P was a direct skip.[86] However, the 1988 Tax Act deferred the occurrence of the direct skip until the close of the period in which the common would be includible in P's estate.[87] This new rule would seem to apply to the transfer because references to an individual or transferor are deemed to include the spouse of such individual or transferor.[88] The provision defers the direct skip until the close of this "estate tax inclusion period" which apparently will occur at the death of S.[89]

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[82] 1988 Tax Act, Sec. 3031(g)(1).

[83] The purpose of the parenthetical, "(determined without regard to any reduction under paragraph (5) for the value of the retained interest)," apparently is to clarify that neither the consideration offset under Section 2036(c)(5) for money which is traceable to P nor the consideration exclusion under this Code section for money which is not traceable to P shall apply in determining the hypothetical gross estate inclusion under Section 2036(c). The 1988 Conference Agreement, at 76, however, appears to contradict this conclusion:

> Under the conference agreement, if a member of the transferor's family provides consideration in money or money's worth for an interest in the enterprise, and it is established to the satisfaction of the Secretary of the Treasury that such consideration originally belonged to such person and was never received or acquired (directly or indirectly) from the transferor for less than full and adequate consideration, a part of the enterprise is not includible under section 2036(c). That part is the portion of the enterprise which would otherwise have been included in the gross estate (*including the value of the retained interest*) times a fraction, the numerator of which is the consideration received and the denominator of which is the portion of the enterprise which would have been includible in the gross estate immediately after the disproportionate transfer (*including the value of the retained interest*). [Emphasis added.]

An example compounds the problem:

> For example, a parent owns all of the common and preferred stock in a corporation worth $2 million. After December 17, 1987, the parent sells to his child the common stock for $1 million not directly or indirectly received or acquired from the parent. If the parent continues to hold the preferred stock until his death, one half of the value of the corporation is includible in the parent's estate.

As discussed in note 17, above, the inclusion of the value of the preferred in the gross estate under Section 2036(c) contradicts the statute and the legislative history. The explanation offered above is consistent with a bona fide sale exception and consistent with the statute. The legislative history should be irrelevant as the statute is unambiguous. Under the literal language of this report, the bona fide sale exception would apply to fully exclude the common stock only if C paid an amount equal to the value of all of P's interests in Corp., even if C was buying only a fraction of those interests. On the other hand, the literal language of the report allows the consideration offset to grow at the same rate as the business appreciates.

[84] 1988 Tax Act, Sec. 3031(f)(1). This provision will apply to all transfers includible under Section 2036 after enactment.

[85] New IRC Sec. 2207B(a)(1).

[86] IRC Sec. 2612(c).

[87] 1988 Tax Act, Sec. 1014(g)(4)(A).

Under Section 2603(a)(3), the GST tax is to be paid by the transferor, S. Because the property is includible in S's estate, S is the transferor and liable to pay the GST tax which may far exceed the value of the preferred stock. S has no right of recovery because Section 2207B refers to estate and gift taxes, but not GST tax.

IV. *The Destruction of Frankenstein's Monster*

Section 2036(c), as enacted, is an obstacle to the use of preferred stock or similar equity interests in a family business, although it would not seem to apply unless a transfer actually occurs. The possibility of gift (rather than estate) tax treatment, in particular, counsels against the creation of such equity interests either intentionally or inadvertently.

But Section 2036(c) also is a bogeyman. The dark side of its 1988 legislative history can be read potentially to apply to every common business or estate planning transaction. The planner can ill afford to ignore the ominous shadow it casts over every joint family investment or venture. Viewed in this fashion—divorced from its literal statutory language and its intended purpose—Section 2036(c) casts a shadowy pall over the entirety of estate planning, subsuming the field. The planner ignores that shadow at his peril.

That shadow will not be permanent, however. Without bold action on Treasury's part, the current unfortunate situation of "taxation by intimidation" will continue to exist. Treasury must act soon, sacrificing the potential revenue gains from the shadows for the desirable aims of certainty and the avoidance of litigation; otherwise, an angry mob will rise up to slay this Frankenstein's Monster. The uncertainty and pervasiveness of the statute will mean expensive, protracted litigation and continuing entreaties to Congress for relief. Eventually, a thousand torches will destroy the Monster.

None of us welcomes this process, which bears an unfortunate resemblence to the litigation involving the special use valuation for estate tax purposes of family farms under Section 2032A. This litigation has been expensive, protracted, and destructive of the very family farms Section 2032A was intended to preserve. For the most part this litigation concerns technical issues without any policy merit. In such cases the courts frequently have favored taxpayers. When the complexity of Section 2036(c) is compared to that of Section 2032A, when the pervasiveness of family businesses generally is compared with that of family farms specifically, when the value of most family businesses is compared with that of most family farms, one can only predict that the volume of litigation under Section 2032A would need to rise exponentially to equal the volume of future litigation under Section 2036(c).

For these reasons, Section 2036(c) has little viability for the long term. However, a solution must be devised to replace Section 2036(c) in such a way that would ensure that succession planning for a family business would not turn solely on the aggressiveness of the owner's valuations. It is beyond the scope of this article to discuss these alternatives. It is not beyond the scope of this article, however, to suggest that Congress be involved in addressing the long-term policy issues implicated and that practitioners be involved in review of the statutory language proposed. ●

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[88] New IRC Sec. 2642(f)(4).

[89] New IRC Sec. 2642(f)(1).

Appendix

Effect of Section 2036(c) on Common Business and Estate Planning Transactions

Transaction	1987 Tax Act	1988 Tax Act	Remarks
Gift of common, preferred retained	Included	Same	Transaction to which Section 2036(c) is directed
Sale of common, preferred retained	Included with offset for consideration	Excluded if consideration is not traceable to seller and for FMV	Application consideration is offset due to legislative history
New recap	Not included	Same	Section 2036(c) requires a *transfer of property*
Short freeze	Not included	Deemed gift at end of freeze	Applies whether a transfer or a change in rights
Minority discount on gift	Not included	Same	Legislative history approves 1 class of stock Application of definition of "disproportionate" appreciation could apply
Gift of non-voting stock	Probably not included	Same	Section 2036(c) should not apply as this contradicts *Byrum* and Section 2036(b) Literal language of statute and definition of disproportionate appreciation could result in application Too hot for Congress to handle, so resolution awaits Treasury notice
Corporate note	Probably not included	Safe harbor implies inclusion: No direct support for application of Section 2036(c) to nonequity interests Qualified debt: (1) Fixed payments; (2) Maturity date 15 years (30 years for mortgage); Demand note okay if for normal business needs; (3) Interest payable at a fixed rate or tied to specified market interest; (4) Interest dates are fixed; (5) Not subordinated to creditors' claims generally; (6) No voting rights except at default; (7) Not convertible to other enterprise interests other than qualified debt.	

Appendix—Continued

Transaction	1987 Tax Act	1988 Tax Act	Remarks
Installment sale of stock to family of all stock	Probably not included	Same, but negative implication of safe harbor for qualified debt	May be perceived as abuse. If no security interest, how does transferor retain an interest in the "enterprise"?
Family note	Probably not included	Same but safe harbor negative implication for start-up debt: (1) Payment of money; (2) In exchange for cash in business; (3) Lender cannot have transferred property, goodwill, customers or business opportunities to the enterprise at any time; (4) Lender cannot have had any interest in the enterprise; (5) Transferee actively manages the enterprise; (6) 6 and 7 requirements for qualified debt	If no security interest, how does transferor retain an interest in the "enterprise"?
Leasebacks and sale employment agreements	Probably not included	Same but safe harbor: (1) Arm's-length agreement; (2) No other enterprise changes; (3) 3-year limit on compensation agreement, including extension at option of service provider; (4) No contingency by reference to gross receipts, income, profits or similar items	1987 Revenue Act defines rights as: "Voting rights, conversion rights, liquidation rights, warrants, options and other rights of value" May be considered part of "income stream" No other enterprise changes or is unexplained
Buy-sell agreements options	Probably included to the extent federal estate tax values are fixed	Same, but safe harbor for option price equal to fair market value at the time of exercise	See how this safe-harbor addresses valuation problems? Are old "buy-sells" grandfathered?
Old recap or freeze	Excluded	Same	1988 Tax Act clarifies that exercise or nonexercise of rights existing on December 17, 1987, will not affect grandfathering
New enterprise; Joint purchase	Probably not included	Same; however, new holding companies caught according to legislative history	The House bill proposed a change in the substantial interest test which was not adopted by negative implication excluding joint purchases and new enterprises from Section 2036(c) Why is the purchase of a interest "in effect" a "transfer"? Creation of new rights or later gift would adversely affect grandfathering

Appendix—Continued

Transaction	1987 Tax Act	1988 Tax Act	Remarks
Traditional trust investments	Probably not included	Same; however, if not a new trust or if funded with an existing enterprise, then Section 2036(c) may apply	Enterprise definition sufficiently broad.
		In that case, unity rule by making spouse's only interests in the trust not qualify for the marital deduction or annual exclusion. Thus, credit shelter trusts are protected even if funded with closely-held business stock	Original unity rule probably did not apply to testamentary transfers, now clearly does apply
Irrevocable Insurance Trust	Probably not included	Same if no inter vivos spousal power of withdrawal marital	Is term insurance an enterprise? 1988 Tax Act includes interest of spouse created by annual exclusion or marital deduction under unity rule.
GRIT	Probably not included	Probably included, but safe harbor for (1) Retention of an income interest in a trust; (2) For 10 years or less; (3) By transferor; (4) Who is not trustee.	How can the ripening over time of a contingent remainder be a "termination, lapse or other change"? Reversionary interests? May be an excluded new enterprise unless funded with an existing enterprise. See Traditional Trust.

PREPARED STATEMENT OF SENATOR JIM EXON

Mr. Chairman, I am extremely pleased to be here this morning. I want to thank you for agreeing to hold hearings on S. 353, my bill to expand the Educational Savings Bond legislation passed last year.

This legislation is pretty straightforward It will open up to relatives and friends the tax exemption on interest earned on U.S. Savings Bonds used for higher education costs that was previously granted only to parents and spouses of eligible students. I have heard concerns expressed that expanding this provision may allow for-profit and other organizations to take advantage of this exemption. Mr. Chairman, let me state unequivocally that is not the intent of this legislation at all. I simply want to encourage grandparents, aunts, uncles, and family friends to help provide educational assistance to students.

I was a cosponsor of Mr. Kennedy's original Education Savings Bond legislation last year. Even before it passed, I was looking at alternatives to expand it. Since its passage, I have received inquiries from individuals expressing strong interest in the program. However, many were disappointed to find out that as a friend or relative, they were ineligible for the exemption. If we are trying to stimulate savings and encourage education, why limit the incentive to such a small audience? When it comes to financing the soaring costs of postsecondary education, every little bit helps.

Most families spend a lifetime trying to save enough money to send their children to college. A college education is part of the American dream. However, with the rising cost of education, it is becoming more and more difficult for families to afford this expense. Ten years ago, grants comprised 80 percent of the average student aid package, with loans making up less than 20 percent. Today, a student aid package is comprised of more than 50 percent loans, leaving grants to make up less than 48 percent of the average aid package.

In recent years, we have tightened up the eligibility requirements for many of the federal financial aid programs making it even harder now for some students to finance their education. For those who do meet the loan eligibility requirements, the thought of facing the beginning of their working life already tens of thousands of dollars in debt is often enough to discourage them from taking advantage of those programs, and therefore, not furthering their education. As the United Negro College Fund so aptly states, Mr. Chairman, "A mind is a terrible thing to waste."

At one point in our history, only the children of the wealthy could afford to attend a college or university. We have come so far since that time that it would indeed be criminal to start sliding back now. I have long held the belief that education is not an expenditure, but an investment. An investment in our future. We must allow all individuals to make that same investment.

By opening up this interest exemption we are not only investing in our educational future, we are also investing in the financial viability of our country. My record here in the Senate on deficit reduction is well-known. I firmly believe we need to reduce the horrendous budget deficits facing this country. Part of the solution to doing that is to stimulate savings. If we can encourage individuals to bolster their personal savings by investing in their country through U.S. Savings Bonds, we are going to help this country out in a lot of ways.

Mr. Chairman, we clearly need to help the lower and middle income families regain their financial stability. Offering them incentives to use proven, safe, and familiar savings and investment tools, such as Savings Bonds, is one step on that road to financial stability. Savings Bonds are familiar and easy. Many individuals can purchase them through a payroll savings plan. By purchasing bonds this way, many do not even miss that small, automatic deduction from their pay check. We must encourage further use of this form of savings.

Many states have already or are looking at setting up a state tuition assistance plan. I applaud such initiatives. However, there is serious concern about how helpful these types of program will be. One of the biggest complaints is that most of these state-backed plans will not necessarily follow a student to an out-of-state school. I submit to you that Savings Bonds are completely portable and will follow a student to any qualified school he or she should choose to attend. A student should not be limited in choices or penalized for choosing an out-of-state institution. No state in this great nation can offer every single program that students in that particular state may need. We must allow mobility and choice.

Mr. Chairman, my bill is but a small step in the long journey of making college affordable again. However, I think it is a very important one. I urge the Committee to give swift and serious consideration to this legislation. Again, Mr. Chairman, I thank you and the Committee for agreeing to hear testimony on this piece of legislation.

May 17, 1989.

Hon. John Chafee,
U.S. Senate,
Washington, DC.

Dear John: During the May 17th Finance Committee hearing you had a couple of questions with regard to S. 353, my bill to expand the Education Savings Bond Act. I appreciate this opportunity to answer them for you.

You asked if this bill had any income guidelines and if, in fact, it was just another exemption that would only help the wealthy. The original legislation passed last year, as part of the Technical and Miscellaneous Revenue Act of 1988, contained income phaseouts. This bill is geared to help the lower and middle income families. The benefit is available to taxpayers filing a joint return if their modified Adjusted Gross Income is below $90,000, with reduced exemptions for those incomes between $60,000 to $90,000. For a single taxpayer, the exemption begins phasing out at $40,000 with the maximum income being $55,000. My bill does nothing to change those guidelines.

The original bill authorizes the interest exemption on Series EE U.S. Savings Bonds only. My bill does not change that. A $50 bond can be purchased over-the-counter, with $100 bonds available through a payroll savings plan. As you can see, this does not place these bonds outside the realm of the possible for lower and middle income families.

You also expressed doubts about the fact that students may not attend school due to the costs involved. According to The Washington Office of the College Board, that is indeed a fact. Many students do not attend for precisely this reason. Unfortunately, statistics on this question are very hard to collect, short of surveying every high school in the United States.

You stated in the hearing, and I would agree with you for Nebraska, that every student in Rhode Island would probably be assured a college education through the community colleges and junior colleges, as well as through the university system if he/she chooses. My question, John, is should an M.I.T.-qualified student be assured only a community college-level education?

I appreciate your thoughts and comments about this bill during the hearing. If you have further questions, please do not hesitate to contact me.

With warm regards.

Sincerely,

J. James Exon,
U.S. Senator.

Prepared Statement of Harry L. Gutman

Mr. Chairman and Members of the Committee: I am honored to be here today as an invited witness to discuss with you S. 659, S. 838 and S. 849, each of which would repeal Section 2036(c) of the Internal Revenue Code.

Section 2036(c) has been described as anti-family and antibusiness. It is said that unless the section is repealed, small business as we know it will disappear. These assertions, made in large part by the organized estate planning bar, should by now be familiar to you. They were most recently voiced in connection with the revision of the generation-skipping tax.

Estate planners like to retain the tax preferences that benefit their clients, so their claims about the effects of loophole tightening provisions should be viewed with some skepticism. Indeed, I would suggest that these extravagant claims more likely indicate that Congress has discovered a tax avoidance practice the practitioners have come to view as an entitlement. Section 2036(c) fits right into this pattern. While as currently drafted it is ambiguous and susceptible of overbroad interpretation, it is responsive to a series of avoidance techniques that aggressive estate planners have exploited with great success over the years. Congress is entirely correct in seeking to curb these avoidance devices. Section 2036(c) should be refined, not repealed.

THE PROBLEM

Over the years, estate planners have learned how to exploit the transfer tax structure by taking advantage of valuation uncertainties, manipulating valuation tables and creating devices to transfer wealth in ways that are difficult for the Internal Revenue Service to detect. The techniques are not mysterious; they are periodically described in the trade literature (although, in some cases, with hesitation due to the fear that if the technique becomes too widely known Congress will react with remedial legislation).

In 1977 Professor George Cooper of the Columbia Law School published a classic article in which he described the then extant avoidance techniques and illustrated how their aggressive employment rendered the transfer tax virtually voluntary.[1] One of the devices Cooper described, the generation-skipping transfer, was addressed by legislation. Another, the use of inappropriate valuation discounts for transfers of less than a transferor's entire interest in property ("minority discounts"), was the subject of a remedial proposal in the Treasury Department's 1984 study, "Tax Reform for Fairness, Simplicity and Economic Growth," and was included in the House version of the Revenue Act of 1987. A third, generically described as an estate "freeze," was the target of Section 2036(c).

While Section 2036(c) has been described as an anti-freeze provision, there is considerable uncertainty as to its scope. It is, therefore, appropriate to identify the types of avoidance devices to which it could be addressed.

THE CLASSIC ESTATE FREEZE

Section 2036(c) is most surely intended to reach classic estate freezes by which corporate or partnership interests are re-arranged with the objective of fixing the value of a portion of the business in the transfer tax base of one party to the transaction while transferring the future growth potential to another (in many cases the natural object of the transferor's bounty) at little or no gift tax cost. I would like to share, in simplified terms, an actual recent example I encountered and I believe you will quickly see both the nature and the scope of the problem.

An individual we will call X owned a large block of the common and preferred stock of a public company. At market prices the stock was worth approximately $8 million. X formed a new corporation ("Newco") and exchanged his stock in the public company for non-voting preferred stock of Newco with a liquidating value of $6.9 million and a non-cumulative 6% dividend preference. Each of X's two children paid $500 for one-half of the common stock of Newco. X maintained voting control of Newco through a complicated arrangement that is not material to this story. No gift was reported at the time Newco was incorporated because X took the position that due to blockage factors the stock he transferred to Newco was not worth in excess of $6.9 million and the preferred stock he received from Newco was worth $6.9 million.

Three years later the assets of Newco were sold for approximately $28 million. X received the $6.9 million to which he was entitled and roughly $21 million was split between his two children. X has managed to transfer $21 million to his children without the payment of any transfer tax.

Had Section 2036(c) been in effect, X would be treated as making a gift, subject to an offset for the consideration paid for the common stock by his children, of the $21 million the children received in liquidation of Newco. In other words Section 2036(c) assures that the transfer of wealth by X is subject to tax. Notice, Section 2036(c) does not prohibit the transaction. It does, however, assure that tax is paid when wealth is transferred. If the section is repealed, these transactions will spring up all over the place again.

THE "BUY-SELL" AGREEMENT

The Mr. X-Newco transaction is a classic, but there are other ways, not as easily recognized, to reach the same result. The "buy-sell" agreement is one example. Suppose X, age 65, enters into an agreement with his son, Y, age 30. The agreement provides that the shares of stock each owns in their corporation cannot be sold to a third party by either while he lives without first offering it to the other at a price equal to the company's book value on the date the agreement is signed. The agreement further provides that upon the death of one of the shareholders, the other will purchase the shares of the deceased shareholder at the same book value price.

This type of agreement serves an important, legitimate business purpose in assuring that control can stay with the current shareholders. The agreement also provides the estate of a deceased shareholder with liquidity. If, however, at the date of X's death, the value of his stock without regard to the agreement is $1 million and the book value is $250,000, X has managed to pass $750,000 of value to Y without payment of transfer tax.

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[1] Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," 77 Colum. L. Rev. 161 (1977).

This is a transaction that Section 2036(c) should (and does) catch. Notice again, Section 2036(c) does not prohibit "buy-sell" agreements. It does require that the price under the agreement be a fair market value price or there will be transfer tax consequences that, until the enactment of that section, could be avoided.

HARD-TO-DETECT TRANSFERS

The foregoing transactions are simple examples of methods that have been devised to exploit valuation uncertainties. Some of those who recognize that Section 2036(c) is directed at a legitimate concern view the problem as simply one of valuation and urge that different approaches, focused more specifically on valuation, be adopted in lieu of the current statute. These proposals have some merit, but I believe that the Section 2036(c) approach, which in effect renders the transfer incomplete until valuation uncertainties are reduced is a more effective way of dealing with the problem. Moreover, in my view Section 2036(c) is directed at a second area in addition to valuation problems. This is the area I describe as "hard-to-detect" transfers.

There are number of easy-to-describe hard-to-detect transfers. For example, a controlling shareholder pays herself too small a salary, thereby increasing retained earnings and the value of the other shareholders' interests. There is a plain transfer of wealth, but it is very unlikely the IRS will ever find it in an income tax audit where it is concerned usually with salaries that are too high. Alternatively, the holder of noncumulative preferred stock can pass the dividend. Again, the wealth transfer is clear, but who will find it?

These transfers will not be detected by a solution that focuses solely on valuation issues. They too are properly within the ambit of Section 2036(c).

CONCLUSION

From the foregoing, it is obvious that I believe Section 2036(c) plays an important role is reducing transfer tax avoidance. However, the uncertainty with respect to its scope must end. This uncertainty has arisen because the section contains terms with no accepted "common law" tax meaning, those terms are not defined in either the statute or its legislative history and the Treasury has yet to promulgate any authoritative interpretative guidance. Moreover, as the members of the estate planning bar have applied their considerable ingenuity to the task of discovering just how broadly the section could be interpreted, they have revealed to the IRS, Treasury and congressional Staffs various avoidance devices of which the latter were formerly unaware, and which they have in some cases indicated they would seek to include within the reach of the statute under their broad grant of regulatory authority.

Section 2036(c) provides special rules for family situations because it is precisely in those situations one is more likely to find disguised wealth transfers. However, when families act at arm's length and can show that to be the case, they should not be subject to rules any different from those governing third party transactions. In the context of the current statute this means that the rules governing the treatment of consideration should be clarified to accomplish this result.

This unfortunate situation of uncertainty should be resolved as soon as possible by a combination of clarifying legislation and prompt Treasury rulemaking.

I will be pleased to answer any questions you may have.

Prepared Statement of Senator Howell Heflin

Mr. Chairman, I want to thank you and the Finance Committee for allowing me an opportunity to testify about efforts to solve the problems caused by Section 2036(c) of the Internal Revenue Code. As you are aware, I am very concerned about the possible effects that Section 2036(c) will have on this Nation's small family farms and family businesses.

This Committee will shortly be hearing testimony from experts about all of the potential problems with this code section. You will no doubt hear that although Section 2036(c) is aimed at one particular estate planning practice, its potential reach is considerably broader. Normal, non-abusive transactions between family members in a family-owned business conceivably may fall within its scope, with serious, unintended consequences.

I will leave it to the experts to explain exactly why Section 2036(c) poses such a threat to family-owned businesses. I would like to impress upon this Committee, however, the point that we should not be making it more difficult for family businesses to grow and prosper. I doubt that any member of Congress seriously desires to force all small and medium-sized family businesses to be liquidated when one generation dies. Yet that may be the result caused by Section 2036(c).

I, of course, favor a complete repeal of this section. I know this view is shared by many experts who are of the opinion that Section 2036(c) cannot be "fixed." The Internal Revenue Service is obviously having a great deal of difficulty in coming up with regulations to govern this section.

Others will maintain that Section 2036(c) is needed to curb an abusive estate planning practice, the "estate freeze." If this is indeed an abuse estate planning practice which needs to be addressed, a narrowly-tailored statute might be in order. But it is my understanding that no hearings were held on this issue before Section 2036(c) was passed in 1987. I think it is incumbent upon Congress to allow an opportunity for those who might be adversely affected by a law to make their case to Congress before it takes action that can have such far-reaching effects. I would respectfully ask this Committee to carefully study whether an estate freeze is in fact an abuse and whether a remedy is necessary.

The family business is of fundamental importance to this nation's economy. We should be taking steps to help family businesses continue and grow. One way to help would be by repealing Section 2036(c).

Prepared Statement of Senator Ernest F. Hollings

As the Cheshire Cat told Alice in "Alice in Wonderland," before we decide where we are going, we must first find where we are.

WHERE WE ARE

1. For eight years running now, we have been spending on an average of $200 billion more than we are taking in.
2. At this moment, we are spending $300 billion more this year than we will take in.
3. The national debt has jumped from $914 billion in 1981 to $2.8 trillion at this moment.
4. Gross interest costs are at $275 billion.
5. Net interest cost this year equals $174 billion.
6. Gramm-Rudman-Hollings is not working—the deficit agreed to by the House and the Senate is nearer $150 billion than $100 billion.
7. Rather than growing out—we are growing in. While President Reagan cut $30 billion from domestic programs, interest costs have jumped from $52 billion in 1981 to $174 billion in 1989. We have started a new spending program of $122 billion for nothing.
8. This new spending program hemorrhages at the rate of $20 to $25 billion each year.
9. The best of government eliminators—Ronald Wilson Reagan—"eliminate the Department of Education and the Department of Energy"—couldn't stop the hemorrhage by cutting programs.
10. Defense accounts for 26% of the budget; entitlements for 48%. With the contracts in the pipeline that cost more to cancel than to complete, with the inflationary costs of operation and maintenance, there will be no real cuts in defense for the next few years. The same for entitlements which are increased by the Summit Agreement $32 billion. Interest cost accounts for 15%. If there is no saving in defense, entitlements and interest costs, the only chance to cut is in domestic spending—11% of the Budget. You can eliminate all domestic spending and still have a deficit. For those worried about making the government bigger—it already is bigger. We're just not paying for it.

So we need taxes. That is where we are. There is no free lunch. In trying to get by, we are depleting our trust funds and putting America up for sale at half-price. The tremendous deficits have caused us to devalue our dollar and every Governor in the land has an office in Brussels or Tokyo telling them to hurry up and buy America while they can. If not owned by foreigners, we'll soon be controlled by foreign financing. We need to finance our own debt.

Let's look at taxes. To begin with, we need a substantial tax—more on the order of a consumption tax. Excise taxes, "sin" taxes, user fees are fiddling while Rome burns. Five to six billion dollars will not do the trick when the interest hemorrhage is jumping $25 billion. Ten to fifteen cents on a gallon of gas won't do the trick. Moreover, both the Senate and the House have just resolved overwhelmingly against a gasoline tax. The reform of income taxes of 1986 is just fully implemented. Obviously, Finance and Ways and Means have no idea of jimmying these figures before they have even taken effect. The only tax that other industrialized nations have used successfully that we have avoided is a consumption tax, the value-added tax. We avoided it for one main reason: it brought far more revenue than was needed. Now the need is bigger than the tax. A VAT at 5%, exempting food, housing and health care, raising $70 billion a year would still take until the year 2023 to eliminate the deficit and the debt. We need to impose such a tax and copper fasten it in a trust fund at the Department of Treasury to be used only to reduce the deficit and the debt—*not to be used for any other purposes.*

I'm not a tax expert; I am prepared to answer the questions as to the VAT mechanism, inflationary impact if any, the regressive nature and the like but we have better witnesses. I have attached a description of VAT. Let me just make the political case.

As Irving Zuckerman pointed out, in the Korean War we raised taxes and held interest rates down rather than raising interest and holding taxes down. With lower interest rates, the United States built over 4,000 plants while waging war and while under the highest inflationary conditions. It must be remembered that higher interest rates are virtually taxes paid to the banks instead of to the government—or in this case to Japan—over $5 billion a month. And in the Vietnam War, President Lyndon Baines Johnson paid for his guns and butter in 1968 with a 10% surtax, delivering a budget in surplus to Richard Nixon.

I testified before you on the value-added tax two years ago. We received 8 votes out of the necessary 12 before the Budget Committee at that time—bipartisan support. VAT is an idea whose time has come. We should have done this rather than Reaganomics 8 years ago. Today, the need is overwhelming. Today, we have fiscal anarchy. We face the S&L problem—put it off-budget—saying it doesn't exist. Our House colleagues have just called the CBO to have the Drexel-Burnham $600 million fine included as an offset to the G-R-H requirements of the urgent Supplemental bill. We refuse to face reality. We have stopped competing. We continue to tell each other that we are fat, rich and happy and that there is no need for government. We have started down the road that England traveled at the end of World War II. When the British withdrew from the colonies, they told her, "Don't worry—instead of a nation of brawn, you will be a nation of brains. Instead of producing products, you will provide services. Instead of creating wealth, you will handle it and become a financial center." And England has gone to hell in an economic handbasket.

It was David Ricardo who told the economic world 200 years ago that each nation should produce according to its comparative advantage. When the British suggested this to our forefathers, Alexander Hamilton wrote his famous booklet, "Report on Manufactures." He told the British to bug off. "We will not remain your colony," said Hamilton. And the first bill to pass our nation's Congress on July 4, 1789 was a tariff bill of 50% on 60 articles, beginning with steel. We used our government to produce this economic industrial giant United States of America. And now the Japanese, emulating us, have used their government to develop the state-of-the-art model of protectionist production and trade. The comparative advantage in today's trade war is government. Now, that war started 200 years ago, is about won by the Japanese. Today, they are richer than you and me. Our per capita GNP income is $19,758 (U. S. Department of Labor); Japan's is $23,356 (Government of Japan). So I appear not to bash the Japanese—you can't fuss with success—but to bash you and me. We live in a dangerous paradox. Overdeveloped Japan is taking the underdeveloped United States to the cleaners. Yes, we have the Donald Trumps and Eisners of Disney making $40 million a year. But we have our citizenry sleeping on the grates outside the Justice Department. Some justice! We have children brought into this world with undeveloped minds—minds that will never develop due to a lack of protein. We have "cities off a hill" rampant with crime and drugs. While our bridges and infrastructure collapse, we are building water lines, sewer lines and libraries in Europe. You and I are the largest employer in Western Europe. But in this country, there is no money for the environment, no money for health care—37% of the population is without—no money for teachers. Fat, rich and happy? No, we are hungry and unhappy. And before we can get happy, before we can provide for our needs, we have got to take our medicine. have got to excise this cancer of interest cost and this can only be done with the trust fund at the Department of the Treasury that is truly a trust fund—never to be used as an offset for any other than the deficit and the debt.

Finally, let me emphasize one point—all taxes are regressive. But if used to protect, if used to develop, if used to open doors, then you have reached the fundamental of democratic government. I heard the economists 40 years ago tell me that a sales tax was regressive. At the time, South Carolina was the poorest of the poor. And we had the greatest need. We had the greatest illiteracy. We had the greatest population to be educated. We were told the poor couldn't afford to be taxed. We enacted a sales tax and allocated it to education. We developed a public school system and technical training to provide skills and today we have a veritable Fortune 500 group of industries and opportunity in South Carolina. Regressive? It's the most progressive thing I have ever done in politics.

VAT DESCRIPTION

A value added tax is a broad based consumption tax that is imposed at each stage of production of goods or delivery of services. I have proposed a "destination-based, invoice-method" VAT of 5%, which exempts food, housing and medical care. It is "destination-based" because the tax is paid in the country where the goods or services are consumed. This means goods consumed in the U.S. are taxed here. Those consumed in other countries are not taxed here.

The "invoice-credit method" refers to the method of calculation of the VAT. The invoice method imposes a VAT at each stage of production and the tax is listed on the invoice. As a taxpayer, I have two entries on my ledger: one for VAT paid on purchases, and one for VAT received on sales. I receive credit for tax paid on purchases and use it to offset tax due on sales. The invoice acts as a paper trail for the IRS. This is repeated at each stage of production up to the point of retail sale. (See attached table which demonstrates how a VAT works.)

Obviously, I view the VAT as the cleanest, most efficient method of raising sufficient revenue to eliminate the deficit and debt. It is a common-sense tax that offers a number of collateral benefits. Under the invoice method, the VAT tax is substantially self enforcing. For instance, if I purchase a product from you, I pay for your value added tax in my purchase price. In order to receive credit for the payment of that tax, I must show, by invoice, offsetting sales including payment to me. My net VAT liability is determined by subtracting the tax paid on purchases from the tax received on sales. So, in order to cheat the government, you have to cheat your customers or your suppliers, and most businessmen are very good at not getting cheated.

Also, because it is destination based, the VAT carries with it very important trade benefits. A VAT is a "border neutral" tax, which means that when a good passes out of the country in which it is produced, the VAT is rebated to the seller. In addition, when the same product is imported into the country where it is to be consumed, that importing country's VAT is added to the product. So, a country without a VAT, like the U.S., is getting the worst of both worlds: foreign goods are cheaper here because the VAT is deleted, and U. S. produced export items are more expensive because a VAT levy is added to the sale price by the importing country. Lester Thurow, Dean of the Sloan Business School at MIT, has said, with good reason, that "The rules of international trade are structured to make you stupid if you don't have a value added tax."

A VAT is also a consumption tax, and as such, has the effect of discouraging consumer binges and hence encouraging savings. The retired Senate sage Barry Goldwater has said, "If you want to discourage something, tax it. If you want to encourage it, subsidize it." Yet, in this country, we perversely tax savings and subsidize borrowing and spending. A VAT would reverse this.

The three most common criticisms of a VAT are that it is inflationary, that it is a money machine for expanding by government, and that it is regressive. The first criticism, that it is inflationary, is overblown, and the other two I have addressed in my bill. Experience shows that while modest inflation can be attributed to a VAT, it is a one-time increase which does not feed the tax-price-wage spiral that most people fear. In addition, deficit reduction made possible by a VAT, and the corresponding lower interest rates would largely offset any inflationary pressure. In fact, it will unburden taxpayers from the cruelest tax of all, the $174 billion in annual interest costs on the rising national debt.

As for the regressive nature of a VAT, my version will exempt food, housing and medical care. Since the poorest Americans spend the bulk of their income on these necessities, these exemptions substantially eliminate regressivity.

Finally, the "money machine" argument is moot under S. 442. All of the revenue from the VAT would go into a sacrosanct dedicated Deficit and Debt Reduction Trust Fund. VAT revenues must not and will not go toward starting up the federal gravy train again.

TABLE 1.—HOW VAT WORKS (a)

[5-percent rate]

	PURCHASE			SALE				VAT	
	Price paid for goods	VAT	TOTAL	"Value Added"	Price charged	VAT collected	Total	Credit for VAT paid	Net to Government
Lumberjack chops the wood	...	...	...	$200	$200	$10	$210	...	$10
Sawmill saws the wood	$200	$10	$210	100	300	15	315	$10	5
Furniture maker assembles the wood into a table	350	15	315	200	500	25	525	15	10
Distributor retails the table	500	25	525	100	600	30	630	25	5
Retail customer buys the table	600	30	630	...	...		...		...
TOTAL				600					30

Table format appears in "Value Added Tax," Price Waterhouse & Co., Nov. 4, 1979, p.4.

PREPARED STATEMENT OF ROY D. NYBERG

Mr. Chairman and Members of the Senate Finance Committee, I would like to thank you for allowing me to appear before you today. My name is Roy D. Nyberg, and I am the owner of Nyberg's Ace Hardware, Incorporated of Sioux Falls, South Dakota. With me is David W. Loving, representing the National Retail Hardware Association and its 18,000 members across the nation. I would like to testify both on behalf of myself and all of the family hardware store owners confronting problems with tax code provisions concerning estate transferal.

As a hardware store owner, I am certainly no expert on the intricacies of the Internal Revenue Code. I pay my taxes, see an accountant when I have to, and hope that the laws passed here in Washington do not interfere with my business. Section 2036(c) of the Internal Revenue Code, however, threatens to choke the very lifeblood of family businesses, the gradual transfer from generation to generation.

When I started working in a hardware store in 1942, it was my ambition to operate a family business. By 1958, after working long hours and learning the business, I was able to start Nyberg's Ace Hardware in Sioux Falls. Then, I only had 4,000 square feet of space and average sales of $35,000 a year.

During the next thirty years, I carefully built up my business, looking forward to the day when I could turn it over to my son. The business steadily grew with a combination of sweat equity, returned capital, the right decisions and good fortune. Today, Nyberg's Ace Hardware, Incorporated is a more sophisticated operation, with annual sales of close to $2.5 million. I have realized part of my dream. I am now 63 years old, and quite ready to pass along control of the operation to my son Kevin, who is now 32 and holds a college degree in business management.

As far back as 1977 I was concentrating on transferal of family businesses. During my first year on the National Retail Hardware Association's Board of Governors, I successfully spearheaded a project researching options available to store owners. The end product of this effort, the book "Who's Next, Please?" was published in 1982, and has guided many store transitions.

For me and thousands of other small businessmen like me, the other half of this dream is to pass on the fruits of my labor to our children. Unfortunately, its not that simple. My accountants and lawyers tell me that if I give to Kevin an interest in the store which would entitle him to the benefit of the future growth in the enterprise, the IRS may assess my estate for taxes as a result of Internal Revenue Code Section 2036(c). These taxes, I am told, will reflect the entire value of the business at transferal. In essence, from the tax perspective alone, it has become advisable for me to sell Nyberg's Ace Hardware, Inc. to a competitor rather than to my own son.

I want to explain to you the dynamics of Nyberg's Ace Hardware so that you will understand why I can't simply give it to my son and retire. While my son has competently taken over much of the day-to-day operation of the store, my participation continues to be essential in several areas. Of these areas, the most critical involves our accounting system. We began transferring inventory and accounting systems to the computer this year. Its been a difficult process, taking two to three years to complete, and only my thirty odd years of institutional knowledge of this business could have efficiently provided the answers to the thousands of questions that come up. These situations highlight the advantages gained by supplementing Kevin's youth and vigor with my skill and knowledge. It just makes good business sense.

Before 1987, many of my peers entered into transactions which are now discouraged under Internal Revenue Code Section 2036(c). By "gifting" all of the future appreciation of their businesses or farms through an estate valuation freeze, they were able to include their sons and daughters into the business. By wisely retaining some of the control of their business' operation, they allowed for a gradual transition in order to ensure that the business remained profitable. They realized, as I do, that there is no single point in time when you achieve full competence and wisdom. Learning the hardware business is a gradual process, and responsibilities and control of the business should increase as you learn. It would be unwise to structure the transfer any other way.

By adding section 2036(c) to the Tax Code as part of the 1987 Revenue Act, Congress prohibited me from using the same flexibility in my estate planning. If I transfer my business today, I will not be able to retain any interest from the standpoint of control, in my hardware store. If estate taxes have to be paid to transfer the store, my executor may be forced to liquidate critical assets to pay taxes. Why must a healthy, dynamic enterprise be crippled to be transferred?

Mr. Chairman, I'm not against paying my taxes, and I'm sure that there are some types of abusive estate planning practices that gave rise to Section 2036(c). But many legitimate transactions, such as the transfer of my business to my son, are treated under the tax code as if they were abusive. Section 2036(c) places unfair restrictions upon the closely-held family businesses that make up the backbone on America.

While I don't have all the answers concerning this issue, I would like to make two suggestions. First, I would like to urge the Committee to reaffirm the importance of family owned businesses by passing Senator Daschle's bill repealing Section 2036(c). Secondly, I would like to volunteer myself and my association to participate in an ongoing dialogue with the Committee concerning appropriate regulation of estate planning practices. Thank you.

PREPARED STATEMENT OF JOSEPH A. PECHMAN [1]

I am pleased to have this opportunity to appear before this committee to examine the case for and against the value added tax. I would like to summarize some of the work I have done at Brookings on the distribution of tax burdens and then discuss the implications of this work for policy regarding the value-added tax.

EFFECTIVE TAX RATES, 1966-1988

I have been estimating the distribution of income before and after taxes for the last two decades on the basis of a unique file of the incomes of the nation's families and unrelated individuals. This file—which is known as the HERGE File—brings together the data for large samples of family units from the Consumer Population Survey of the Bureau of the Census and the IRS sample of individual income tax returns. Estimates of the taxes paid to the federal, state, and local governments were made for each unit in the samples and then blown up to national totals to obtain a distribution of tax burdens by income classes. HERGE files were developed for the years 1966, 1970, and 1975, and the 1975 file was projected to 1980 and 1985. The results of this project are summarized in my book, *Who Paid the Taxes, 1966-85?* (Brookings Institution, 1987).

The conclusions of this study are summarized in the attached table 1, which gives the effective rates of federal, state, and local taxes by population percentiles for the years 1966, 1970, 1975, 1980, and 1985. (We made estimates on the basis of eight different sets of incidence variants, but I am concentrating on the variant which I consider the most realistic, namely, that taxes on labor are borne by labor and taxes on capital are borne by capital.) According to these estates, the tax burdens of the bottom 90 percent of the income distribution have not changed very much during this period of almost two decades. By contrast, the tax burdens of the top ten percent of the income distribution declined, especially those of the top 5 percent and 1 percent of the distribution. For the top 5 percent, the reduction in effective tax rates between 1966 and 1985 amounted to 20 percent (from 32.7 percent to 26.0 percent);

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[1] Joseph A. Pechman is Senior Fellow Emeritus and formerly Director of Economic Studies at the Brookings Institution.

for the top 1 percent, the reduction was 36 percent (from 39.67 percent to 25.3 percent).

The explanation of this large drop in tax burdens of the highest income recipients is that, throughout this period, top individual income tax rates were reduced sharply and the corporation income tax dwindled to relative obscurity at the federal level. In 1966, the highest individual income tax rate was 70 percent; by 1985, it had been cut to 50 percent. The effective corporate tax rate declined from 32.8 percent to 16 percent during this period. The reduction in the corporate income tax reflected primarily the investment incentives introduced in the 1960s and liberalized in the 1970s and 1980s. The proliferation of personal deductions (e.g., IRAs) and tax shelters were also major factors in the reduction of the tax burdens in the top part of the income distribution.

Since 1985, the distribution of tax burdens has changed largely as a result of the enactment of the landmark Tax Reform Act of 1986. This act increased the progressivity of the tax system in several respects; first, it raised the personal exemptions, the standard deduction, and the earned income credit, all of which reduced the tax burdens at the lower levels of income; second, it raised the corporate income tax by about 20 percent; and, third, it eliminated IRAs and other deductions and removed the tax advantages of tax shelters. The question is whether this change in tax policy—a change which I heartily supported and still support—had much of an effect on the overall distribution of tax burdens.

My response to this question is that the 1986 act increased tax progressivity, but by only a small fraction of the progressivity decline in the prior two decades. Unfortunately, I have not been able to prepare a MERGE file for years later than 1985. As a substitute, I estimated the distribution of tax burdens in 1988 on the basis of the recent estimates of the changes in the distribution of federal taxes by the Congressional budget office. (For the purpose of this exercise, I assumed that there was no change in the effective state-local tax rates between 1985 and 1988.) The last column of table 1 shows my estimate of the combined federal, state and local effective tax rates in 1988, which includes the effect of the increase in social security tax rates since 1985 and the Tax Reform Act of 1986.

It is clear from table I that the progressivity of the U.S. tax system increased between 1985 and 1988, but not much. Taxes declined somewhat in the first three deciles and increased in the top seven. At the very top of the income distribution, the 1986 reform restored about half the reduction in effective tax rates between 1980 and 1985, but left them far below the 1966 levels. Thus, the top 5 percent paid 27.4 percent of their income in taxes in 1988 as compared with 32.7 percent in 1966; the top 1 percent paid 26.8 percent in 1988 as compared with 39.6 percent in 1966.

POLICY IMPLICATIONS

The inescapable conclusion from these figures is that the well-to-do in our society have had very large tax reductions in recent years, while the taxes at the low and middle income levels have not changed very much. In these circumstances, it seems to me that consideration should be given to redressing this imbalance if and when taxes are raised to reduce the deficit.

The first and best alternative would be to continue to broaden the base of the income taxes by eliminating unnecessary deductions and tax favors that remain in the law. Some examples are the exemption of capital gains transferred by gift or at death, numerous fringe benefits that are not taxable to employees, excessive tax benefits of home owners, and the exclusion of all Medicare benefits and part of social security benefits from the tax base. The second alternative would be to raise the excise taxes on liquor, tobacco, and gasoline. These taxes, which are levied on a specific dollar basis per unit, have been eroded by inflation; yet they are important in recouping at least some of the costs imposed upon society by drinkers, smokers, and drivers. At the very least, they should be adjusted for the inflation of the past thirty years, and I would also support even larger increases in oil or gasoline taxes in order to promote energy conservation.

However, as a practical matter, it is clear that income and excise tax reform will not provide enough revenue to achieve a budget balance in the foreseeable future. I believe that the additional revenues should be obtained by a flat percentage-point increase in all the income tax rates, both corporate and individual. If the rates were raised by 1, 2, or 3 percentage points, the 15 percent rate would rise to 16, 17, or 18 percent, the 28 percent rate to 29, 30 or 31 percent, and the corporate 34 percent rate to 35, 36, or 37 percent. Each percentage-point increase in these rates would bring in about $33 billion in fiscal year 1994, so that two points would raise half the currently estimated deficit in that year. Now that we have a better tax base, it would be appropriate to use the income taxes to raise additional revenues when necessary. Moreover, a top individual income tax rate of 30 or 31 percent cannot be regarded as punitive or harmful to economic incentives.

What would be inappropriate in my view would be to introduce a value added tax, as some are suggesting. This tax is similar to a retail sales tax, except that the revenues are collected at all stages of the production and distribution process rather than at the retail stage alone. These taxes are regressive and impose unnecessarily heavy burdens on the lower income classes. Our income tax rates are now at their lowest levels in the entire postwar period and income tax liabilities are modest at all income levels. As a result of the 1981 legislation, we are now collecting at least $200 billion less annually from the income tax than we would have collected under the pre-1981 law. In these circumstances, more revenues should come from the income taxes, which are paid by those who have the ability to pay. There is no reason to impose the burdens of a sales tax on the people who are having the most trouble making ends meet.

The Tax Reform Act of 1986 was a milestone in tax history. Additional reform is needed to close the remaining loopholes and to continue the progress made to eliminate unnecessary deductions. Equally urgent is to get control of the federal budget and this will require higher taxes. Tax reform can help, but I believe it will also be necessary to raise the income tax rates to achieve our budgetary objective. In view of the reduction in tax progressivity in recent years, it would be unconscionable to consider the distinctly inferior alternative of a sales or value-added tax.

TABLE 1.—EFFECTIVE RATES OF FEDERAL, STATE, AND LOCAL TAXES, BY POPULATION DECILE, SELECTED YEARS, 1966–1988 [1]

[In percent]

Population percentile [2]	1966	1970	1975	1980	1985	1988 [3] (est.)
1st decile [4]	16.8	18.8	19.7	17.1	17.0	16.4
2nd decile	18.9	19.5	17.6	17.1	15.9	15.8
3rd decile	21.7	20.8	18.9	18.9	18.1	18.0
4th decile	22.6	23.2	21.7	20.8	21.2	21.5
5th decile	22.8	24.0	23.5	22.7	23.4	23.9
6th decile	22.7	24.1	23.9	23.4	23.8	24.3
7th decile	22.7	24.3	24.2	24.4	24.7	25.2
8th decile	23.1	24.6	24.7	25.5	25.4	25.6
9th decile	23.3	25.0	25.4	26.5	26.2	26.8
10th decile	30.1	30.7	27.8	28.5	26.4	27.7
Top 5 percent	32.7	33.0	28.4	28.9	26.0	27.4
Top 1 percent	39.6	39.0	29.0	28.4	25.3	26.8
All deciles [5]	25.2	26.1	25.0	25.3	24.5	25.4

1. Assumes corporate income and property taxes are borne by capital income.
2. Arrayed by comprehensive income which includes transfer payments, employee fringe benefits, net imputed rent, and corporate earnings allocated to shareholders.
3. Projected from 1985 on the basis of CBO estimates of changes in effective federal tax rates. Assumes no change in effective state-local tax rates between 1985 and 1988.
4. Includes only units in the sixth to tenth percentiles.
5. Includes negative incomes not shown separately.

Source: Brookings MERGE files (revised).

PREPARED STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

As the Finance Committee looks at possible corrections to Section 135 of the Internal Revenue Code with respect to Educational Savings Bonds, I hope that serious attention will be paid to various educational trusts already in existence. I know that the Chairman has met with Governor Blanchard of Michigan to discuss rulings from Treasury on the Michigan Educational Trust. As you know, the State's educational trust fund is now required to pay taxes on the inside build up of the fund. Beneficiaries are also subject to tax when the fund is eventually used. Such taxation on the inside build up is counterproductive to our efforts to expand educational opportunity for all Americans.

PREPARED STATEMENT OF RICHARD F. ROSSER

Mr. Chairman and Members of the Committee: I am Richard F. Rosser, president of the National Association of Independent Colleges and Universities, representing 830 private colleges and universities including research universities, liberal arts colleges, junior colleges, church-related colleges, and historically black colleges. I am here today to discuss the importance of federal incentives to save for college, the concern that our members share with students and parents about the increasing costs of attending college, and some of the recent trends in financing higher education that make savings a bigger part of families' ability to pay for a higher education.

First, I would like to commend this Committee for its leadership in enacting the Education Savings Act last year. This program will appeal to many low- and middle-income families because it provides a convenient and effective mechanism for college savings, and an incentive to begin planning for children's college education long before the first college recruitment brochure is received. Without the hard work of individual members of this Committee, the Education Savings Act surely would not have been possible.

We have been able to document that families recognize the importance of saving for college, but need help to make saving a reality. In 1984, our research organization, the National Institute of Independent Colleges and Universities (NIICU) together with the Roper Organization, conducted a poll on attitudes toward saving for children's college expenses. The study revealed that 77 percent of parents with children of pre-college age expect, or at least hope for, their children to go to college. Two-thirds of parents see themselves as having the primary responsibility for financing college. When asked whether they were currently saving for their children's college education, parents of prospective college entrants indicated that only half are currently saving, that they saved an average of $517 in 1984, and that they started saving for college when their oldest child was four years old. The half who are not currently saving say they cannot afford to, but two in three plan to save later. About 43 percent of the parents said that they would save more if the federal government provided a "tax break" for educational savings.

An especially interesting finding of the NIICU/Roper study showed that half of the general public said they would save for the education of someone other than their own child (grandchild, niece, etc.) if a federal incentive were available to them. This broad interest in education and support of children by family members other than parents should be encouraged and nurtured.

Indeed, students and their families have accepted the responsibility for paying the major portion of expenses at independent colleges and universities. NIICU's analysis of data collected by the U.S. Department of Education shows that 60 percent of all undergraduate expenses at private colleges and universities in 1986 were paid by students and their families. Even the 65 percent of our undergraduates on financial aid paid 30 percent of the cost of their education. And this does not include loans which they must repay after graduation.

Families are very concerned about being able to pay for their children's college education. A recent study by the American College Testing Program found that in the 1987–88 academic year, the average annual cost of a college education including tuition, books and room and board—ranged from $6,000 at two-year public schools to $15,400 at private universities. Without financial assistance, the study noted, families need a median income of about $49,900 to cover a child's expenses at a two-year public school, and about $94,800 for a private university. Comparing these estimates with Census Bureau data on family income, the study reported that only 18 percent of children aged 18 or younger live in families that can afford even the most inexpensive college education at a two-year public school. Fewer than 6 percent live in families that can afford a four-year private college.

Private colleges and universities are devoting an increasing proportion of their institutional resources to providing assistance to financially needy or academically deserving students. In 1987–88, private colleges and universities provided $2.3 billion in financial aid to undergraduates—an increase of 489 percent from the $397 million provided in 1970–71. Most of this increase occurred in the 1980s in response to cutbacks in the availability of federal aid, particularly grant assistance, and an effort to reach out to increasing numbers of economically disadvantaged students. On average, 14 percent of an independent institution's budget is allocated to student financial assistance.

The financial commitment that our institutions have made has enabled students from a variety of backgrounds to attend private colleges and universities. We enroll the same proportion of minority students as do public colleges and universities. Last year 30 percent of our entering freshmen were the first generation in their families to attend college. And we enroll twice as many students from families earning less than $30,000 per year than we do from families earning more than $75,000 per year.

One direct outgrowth of concerns about the affordability of college has been that individual colleges, states and financial institutions have attempted to devise limited strategies to spur savings. Approximately 12 private colleges developed innovative contracts to prepay tuition before the child reached college age. Several of these are no longer operational because they have not proven to be financially feasible for the institutions. Numerous states have explored possibilities of state plans. These plans have a number of different characteristics, but most common are limitations on where the students can use the funds saved, such as at a particular institution or within a particular state. Private savings plans typically require larger investments and are designed for more sophisticated investors.

The Education Savings Act adopted in the last Congress is an important addition to these options. It will help generate savings among a broad spectrum of families to marshal resources to help meet college expenses. Education savings bonds will enable families with as little as $50 to make a commitment to their child's future education. There are no other savings vehicles available that return so much for so little. These savings bonds also may stimulate growth in the personal savings rate among Americans—currently 5.7 percent of disposable income in the first quarter of 1989 and down from a post-World War II peak of 9.4 percent in 1973.

This is not to say that the Education Savings Act is perfect as adopted. There are several technical changes which, in our opinion, would strengthen the law. Senator Exon's bill, S. 353, proposes that it would be appropriate to broaden the potential purchasers of the bonds. As enacted, the Education Savings Act limits the purchasers to parents and students, provided that they are at least 24 years old. One of the most important changes in the financing of higher education today is the much larger role played by family members other than parents. Grandparents may have more substantial reserves and our own experience shows that they are willing to provide savings bonds as gifts to grandchildren. Corporations and businesses also are showing an increasing interest in supporting scholarships and providing opportunities to promising students to attend college. A broader definition of eligible purchasers could effectively channel these strong motivations into a more effective savings program.

Mr. Chairman, we are just beginning to learn how to make college savings an important national priority. We still have lessons to learn from the still unimplemented Education Savings Act which may allow us to better focus the incentives in the future. We are delighted to have this new program in place and urge its immediate implementation.

Thank you.

Prepared Statement of Thomas E. Swanstrom

Mr. Chairman and members of the Committee, my name is Tom Swanstrom. I am the Chief Economist of Sears, Roebuck and Co. and am today representing the American Retail Federation (ARF), which was founded in 1935 to provide retailers with a unified and central voice for rapid and effective response to government regulations and policies affecting the industry and its customers. Headquartered in Washington, the Federation serves as an umbrella organization encompassing a variety of large and small retailers, state retail associations, and national retail associations. The Federation's uniqueness is in the nature of this membership which includes 50 state retail associations, 20 national retail associations, and corporate retailers from the largest general merchandise department stores and discount store chains, to small speciality stores. The retail industry accounts for nearly one quarter of GNP and employs more than 16 million persons.

THE ISSUE

In recent years the concept of a value-added tax has often been proposed as a remedy for many of the problems of the U.S. economy. Such problems include the federal deficit, the adverse trade balance, productivity shortfalls, a lack of savings, overconsumption, and under-investment. The advocates of a VAT paint the picture that such a tax will magically correct any problems that the U.S. may have in these areas. But, in the end, what most want simply boils down to some oF the money that a VAT would generate.

We feel that a VAT would have very little impact upon most of these economic issues. In addition the ones that would be impacted are likely to move in an opposite direction than desired. Savings, for example, is likely to be depressed rather than stimulated by a value-added tax.

BACKGROUND

Consumption taxes can be broadly classified as belonging to five major categories: manufacturers excise taxes, national retail sales taxes, consumed-income taxes, business transfer taxes, and value-added taxes. Most of these have little support in the United States.

National retail sales taxes, for example, have a host of problems. Most importantly, a national sales tax would conflict directly with the tax collection efforts of state and local governments. In addition, it would be very difficult to differentiate between consumer purchases and business purchases of goods. The latter should be exempt since they are used to produce other goods. Another problem is that, according to the rules of GATT, such a direct tax could not be rebated at the border.

Consumed-income taxes are often preferred by economists on a theoretical basis but in practice have proved unworkable. Consumed-income taxes would replace personal income taxes and no taxes would be collected on savings or investments. This type of tax has been tried in India and Sri Lanka but turned out to be extremely complicated to administer, partially because their tax systems became riddled with exemptions and omissions.

A business transfer tax is similar to a VAT except that it is not applied at the retail level. Canada considered such a tax, but no country has ever implemented one.

Most talk of consumption taxes revolves around selective manufacturers' excise taxes (such as gas taxes) or value-added taxes. I will focus my attention on the latter. VAT's can be subdivided by type and by method of calculation. By type, the differentiation is based on how capital goods are treated, that is full deduction (consumption type), depreciation deduction (income type), and no rebates for capital goods (product type). Proponents of VAT's tend to favor the consumption type.

The calculation methods that could be used for VAT's are tax credit, addition, and subtraction. Most countries with VAT's use the tax credit method whereby taxes already paid are deducted from taxes due on sales or output. Despite the more widespread usage of the tax credit method, some economists prefer the subtraction method which involves deducting purchases from taxable sales. But, there is some doubt that the subtraction method would qualify for border tax rebates under GATT rules.

HISTORY

The first value-added tax was introduced in France in 1954 and spread to the rest of the European Economic Community by the late 1960's. In every case these VAT's were replacements for cascade turnover taxes, which, although similar to VAT's, were applied only at the manufacturing level. The European value-added taxes are hidden in every country except Denmark and range from 2% on some necessities in Italy to 37% on some cars in the Netherlands.

Canada will initiate a VAT on January 1, 1991 and it will be applied at a 9% rate on nearly all goods and services. As in Europe, the Canadian VAT is also a replacement for a similar manufacturers' excise tax that has been in place for more than sixty years. This excise tax was considered very inefficient and actually discriminated in favor of foreign competition since it was not applied to imports.

Japan recently introduced a value-added tax, which is somewhat dissimilar from those of Europe and Canada. Japan's VAT partly replaced excise taxes, but it also was used to help offset cuts in income and inheritance taxes. The net result of these tax moves was a cut in overall taxes for individual taxpayers. Despite this favorable impact, opposition to the VAT was a primary factor lying behind the political problems of the Takeshita administration in April. Inflationary price increases erupted immediately after the VAT was implemented and even occurred in the small business sector that was exempt from the tax.

What have we learned from these historical experiences with VAT's? For one thing, VAT's have tended to fuel government spending. For another, since VAT's are hidden, there is little public recognition that they exist. Thus, it becomes much easier to raise a VAT than a more visible tax. As Martin Feldstein has said "Once in place it tends to rise inexorably."

VAT's have also proven to be inflationary. When they replace similar-type taxes, this inflationary effect may be minimized. But when they are raised, there is a passthrough to inflation with a lag. The United Kingdom, for example, doubled VAT rates in 1979. Within two years, this resulted in a doubling of the inflation rate.

The final problem with VAT's is that their administrative costs have proven to be very high. Such costs would be less if one simple rate were applied. But, all of the European countries have exempted some goods or services and all, except Denmark, have set up differential rates on various luxuries and necessities.

DIFFERENCES BETWEEN EUROPEAN EXPERIENCES AND THE U.S. SITUATION

The primary difference is that European VAT's replaced other similar taxes. As Lindley Clarke has said, a major reason for "Europeans enthusiasm for VAT'S stemmed from the trouble they were having collecting income taxes." A U.S. VAT, on the other hand, would be much more likely to be an add-on tax and thus potentially far more inflationary. Some have proposed that U.S. corporate and/or income taxes be replaced by a VAT. Such an assumption that Congress would do away with either of these taxes has to be considered very unrealistic.

Another difference is that, over time, European governments have been very inefficient at collecting income taxes. Thus, VAT's became in many cases the only effective way to ferret out tax liabilities. Despite some minor problems, the U.S. income tax system is a model of efficiency when compared to the European systems. Also, Europe does not have state or local taxes. The multiplicity of taxing jurisdictions in the U.S. makes it much more likely that a federal VAT would infringe upon the administrative sovereignty of other governmental units.

THE U.S. EXPERIENCE WITH VAT'S

The only U.S. VAT is one in Michigan called a single business tax, which is basically an addition method VAT. It replaced various corporate taxes and lowered tax liabilities for manufacturers and raised them for services. The Michigan VAT has been very unpopular with business, especially small business since it is not limited to corporations. It was introduced in 1975 and has not been raised since then.

WHY WOULD A VAT BE BAD FOR THE U.S. ECONOMY?

VAT proponents often stress that the prime advantage of a VAT is its enormous potential for raising revenue. On a European rate basis, a VAT would collect $300 billion and even a lesser 5% VAT with no exemptions would probably wipe out the federal deficit. We see this "cash cow" aspect of a VAT as its prime disadvantage. Any tax that can easily generate such large sums would automatically remove much of the spending restraint discipline from the political process.

In recent years the savings rate issue has become a "straw man" for those individuals and groups advocating tax increases. In their views, low U.S. savings is an intractable problem that can only be solved if consumption can be discouraged through higher taxes. Most of these proponents fall back on value-added or consumption taxes as being the best way to both cut consumption and raise savings.

What they ignore, however, is that any such tax increase would reduce both consumption and savings. In fact, the initial response of consumers to a VAT is likely to be one of maintaining their spending levels by reducing savings. Thus, the savings rate could be severely depressed by a value-added tax. In addition, the falloff in consumption would probably precipitate a recession since consumers would stock up on goods before the VAT was imposed and then cut their spending sharply.

What is interesting is that VAT proponents give lip service to the role of a VAT in cutting the federal deficit and raising savings. But, what they really want is some of the money. The VAT camp is an unlikely assortment of liberals and conservatives. Some want the VAT to increase social spending; others want it to push up defense spending. Many see the VAT as a way to revive the investment tax credit, while others want it to offset taxes on business. In any case, with the substantial sums of money involved in a VAT, the lobbyists would be out in full force to divvy it up.

One of the supposed prime advantages of a VAT is that, under the rules of GATT, it would be rebatable at the border as an indirect tax. But, with the VAT as an add-on tax, there would be absolutely no benefits to the U.S. trade balance. This is because the prices of U.S. exports at the border after the VAT rebate would be exactly the same as they are now. Imports would have the VAT applied at the border but domestic sales of U.S. manufactured goods would also be subject to the VAT. Thus, again the competitive posture of U.S. goods would be exactly the same as it is now (although demand for both domestic and imported goods would erode due to the higher prices stemming from the VAT).

Thus, a VAT would not produce what its advocates proclaim: substantially lower deficits, higher savings, and an improved trade balance. In addition, a VAT has other decided disadvantages. For one thing any type of consumption tax is very regressive. Low-income families and the elderly would be hit especially hard since their consumption often exceeds their incomes. As the National Bureau of Economic Research has said: A VAT would be economically indistinguishable from a "wage tax plus a levy on the elderly population." The VAT would also impact all consumers in terms of its effects upon inflation.

Small and growing businesses would be hurt badly by the VAT since the taxes would have to be paid even if the companies were unprofitable. For all businesses a VAT would be another enormous administrative burden that the federal government would require but not pay for. The government itself would, of course, also have to set up a costly new agency to administer the program. If differential rates were instituted on various categories of merchandise (as is the case in Europe and likely here), these administrative costs would be 60 to 80% higher than under a single-rate VAT. A VAT would also make it much more difficult for state and local governments to raise their own taxes.

But, the most onerous aspects of the VAT involve its effects upon the political process. This is because a VAT would not be out in the open like most taxes but would instead be hidden from those who pay it. The result would be that when money is needed for governmental programs, raising the VAT would be an easy and painless way for lawmakers to fund them. Studies have shown that governments that rely on VAT's have significantly higher levels of spending than non-VAT countries. The same would happen in the U.S. as the traditional restraints on spending would loosen considerably and the federal government share of GNP grows accordingly.

CONCLUSIONS

We believe that the imposition of a VAT in the United States would be ineffective as a measure to reduce the federal deficit. Most of the revenues generated would likely be used to fuel spending rather than applied to the deficit reduction.

In addition, a VAT would sharply raise the tax burden on the U.S. economy. A 5% VAT, for example, would increase the federal taxes share of GNP from 20.5% to 22.5%. Our studies have shown that the implications of such a large tax burden are clear. Economic growth will deteriorate as it has inevitably in the past during similar high-tax periods. For example, when the Federal tax burden reached 21.5% of GNP in 1981, it was followed by the 1982 recession.

The high tax level as well as the sharply negative impact of a VAT on consumer spending would force the Federal Reserve to step up money supply growth to offset a weakening economy. The indirect effect of easier monetary policy along with the direct impact of a VAT on prices and cost-of-living clauses would then lead to accelerating inflation. In turn, this higher inflation would raise the government's costs for means-tested entitlements and its own purchases. Again, the results are clear. The effects of a VAT in slowing the economy and raising inflation would increase the federal deficit not lower it.

How do we escape the treadmill of growing federal debt without the quick fix of a value-added tax? Put simply, hold down federal spending. Both the OMB and CBO have projected federal revenue growth of $80 billion in each of the next four years. If only one-half of those revenues were dedicated to reduce the deficit, the federal budget would be balanced by 1993. This would still leave the sizable sum of $40 billion per year to fund new programs and provide increases for existing ones.

We have developed a proposal that allows even more funds free for new initiatives. Specifically, we recommend that Social Security be excluded from budget limitation standards. The remaining Federal spending would increase in line with the OMB parameters for fiscal 1990. Between 1991 and 1995 spending would then be allowed to grow at the rate of inflation. Such a program would eliminate the deficit by 1995, and over these five years, result in cumulative savings of more than one-half trillion dollars in federal spending.

It is our view that such a spending restraint program is the best way to deal with the federal deficit problem. Any quick-fix solution using value-added or other taxes would create more problems than it solves. The continuing health of the U.S. economy is heavily dependent upon the tax load on American taxpayers. To keep the United States strong, that tax burden should be lowered not raised.

PREPARED STATEMENT OF SENATOR STEVE SYMMS

Mr. Chairman, I continue to hear horror stories associated with estate taxes and family businesses. On March 17, I introduced S. 659 to repeal the restrictions added under the Revenue Act of 1987. Most recently, my colleague, Senator Daschle, introduced similar legislation to attack this death tax. I believe that Congress should immediately act on this measure to ensure that those individuals that have worked a lifetime to provide an estate for their heirs are not in jeopardy of turning all that they own over to the Federal Government in taxes.

As I continue to talk with constituents that are concerned about current tax laws, I am increasingly becoming aware of the urgency of this measure. Legislative history of the Internal Revenue Code clearly shows that Congress has consistently broadened the scope of retained interests includable under section 2036. In addition, Congress has supported the IRS in its attempt to prevent avoidance of the estate and gift taxes through transfer of ownership of property but retention of an interest in the property. All of this, until 1988, still allowed estate planning that would not completely bring about the collapse of a family business. However, the situation now excludes the typical estate freeze and assigns a tax rate on appreciation of up to 60%.

Perhaps the worst aspect of this ghastly tax is that its application is so far reaching that a child could be required to pay this tax at the death of a parent, even though the child may have originally purchased the interest in the business from the parent for fair market value and even though the appreciation is attributable to the efforts of the child over a long period of time. In addition, these taxes could even be payable on a lifetime sale of the business to outsiders, *above and beyond all capital gains taxes!*

Family owned businesses are not an institution of America that Congress should contemplate taxing into extinction. Businesses provide jobs, tax revenues, and products and services that are absolutely essential to the well-being of America. By no means is it easy to build a family business; what's really tragic is that Congress has, through its infinite wisdom, created a taxing system to crush the backbone of America—the family owned business.

That a family business would have to be sold to pay estate taxes is borderline authoritarian. If American government has evolved to the point of destroying such a fundamental part of society, I question what will come under the congressional hatchet next.

My legislation repeals section 2036(c), which treats the typical estate freeze after December 17, 1987, as though it never occurred. Under current law, upon the founder's death, the entire value of the business reverts back to the founder's estate, and the heirs or estate must either come up with vast sums of cash or stand aside as the government causes liquidation in order that estate taxes might be met. I urge the support of all senators in the current effort to protect family owned businesses and ask that S. 659 be immediately considered.

PREPARED STATEMENT OF DANA L. TRIER

Mr. Chairman and Members of the Committee: I am pleased to be here today to testify concerning the following tax bills: (1) S. 659, S. 838 and S. 849 (repeal of estate freeze provisions); (2) S. 442 (value added tax); and (3) S. 353 (amendment to educational savings bond provisions).

REPEAL OF ESTATE FREEZE PROVISIONS: S. 659, S. 838 AND S. 849

Background

Section 2036(c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987 and was further amended by the Technical and Miscellaneous Revenue Act of 1988. The statute was intended to eliminate the perceived unfair transfer tax advantages of estate valuation freezes. An estate freeze is a technique whereby the value of certain property is frozen for estate tax purposes. The freeze is accomplished by transferring the future appreciation in a business or other property to a younger generation while the older generation retains a non-appreciating interest in the business or property that provides income or other significant rights with respect to the business or property. Although there are a variety of transactions and arrangements that can be used to achieve an estate tax freeze, the most typical example is a transfer of common stock of a business by a parent-owner to children coupled with the parent's retention of preferred stock. Prior to the enactment of section 2036(c), no part of the value of the transferred common stock would have been included in the parent's estate.

The legislative history of this provision indicates that Congress was concerned about estate freezes for several reasons. First, it was thought that such arrangements too often permitted wealth to pass outside the transfer tax system. This could result from an initial undervaluation of the transferred appreciation interest or because of subsequent action or inaction by the transferor with respect to the retained frozen interest. For instance, in the typical freeze I described earlier, the older generation's failure to take preferred dividends or to exercise other rights in an arm's-length manner could in effect transfer wealth to the younger generation. In addition, the general effect of an estate freeze transaction was thought to be essentially that of a transfer of an interest in property with retention of the enjoyment of the entire property. Such transfers have long been treated under the estate tax law as incomplete for estate tax purposes.

Section 2036(c) applies if a person who holds a substantial interest in an enterprise in effect transfers property having a disproportionately large share of the potential appreciation in such interest while retaining an interest in the income of, or rights in, the enterprise. The legislative history describes an "enterprise" as including any business or other property which may produce income or gain. A person holds a "substantial interest" in an enterprise if he or she owns, directly or indirectly, 10 percent or more of the voting power or income stream, or both, in the enterprise. An individual is treated as owning an interest in an enterprise which is directly or indirectly owned by any member of such individual's family.

Where the statute applies, the value of the transferred property will be included in the transferor's estate if the transferor continues to hold the retained interest until death or will be treated as the subject of a deemed gift by the transferor at the time the transferor's retained interest in the enterprise terminates or the transferred appreciation property is disposed of outside the transferor's family. In either case, the original transfer will be taken into account so that the general effect of section 2036(c) will be to tax the post-transfer appreciation in the value of the transferred property through the time of such inclusion or deemed gift.

Section 2036(c) generally does not apply where the transferor receives full and adequate consideration for the transfer of the disproportionate appreciation interest. This exception is not available for transfers to family members, but the statute generally does not apply to the post-transfer appreciation attributable to consideration paid by the younger generation from its own funds for the appreciation interest.

The statute contains several safe harbors for common transactions that were thought not to provide significant opportunities to transfer wealth outside the transfer tax system but that otherwise might be reached by section 2036(c). For example, the retention or receipt by the transferor of debt that meets certain qualifications will not be considered a retained interest that could trigger the statute. Further, the statute would not apply solely because the transferor enters into an agreement for the sale or lease of goods or other property, or the providing of services, if the agreement is an arm's-length agreement for fair market value and does not otherwise involve any change in interests in the enterprise. The statute also contains safe harbors for options to buy or sell property at fair market value as of the time the option is exercised and for grantor retained income trusts that meet certain requirements.

S. 659, S. 838 and S. 849

All three of the Bills under consideration, S. 659 introduced by Senator Symms on March 17, 1989, S. 838 introduced by Senator Heflin on April 19, 1989 and S. 849 introduced by Senator Daschle for himself and Senators Heflin, Boren and Symms on April 18, 1989, would repeal section 2036(c) retroactively in its entirety.

Discussion

Although section 2036(c) was intended to address an area of significant tax avoidance, the statute has been criticized for being both overly broad and uncertain in its application. We understand the views of those who have expressed such concerns, and we share some of those concerns.

However, the repeal of the statute at this time would raise serious revenue concerns. The revenue loss that would result from the repeal of section 2036(c) if such repeal were effective as of the date of its original enactment as is proposed in the bills under consideration would, according to our estimates, be as follows (in millions):

1989	1990	1991	1992	1993	1994	1995
-2	-25	-72	-146	-249	-384	-555

The Treasury Department is willing to consider reasonable suggestions for amendment of section 2036(c) that would not substantially compromise the revenues or the basic tax policy goal of preventing significant bypassing of the transfer tax system through estate freeze techniques. The repeal bills before the Committee today would not satisfy either requirement, and we must therefore oppose them.

VALUE ADDED TAX: S. 442

Background

The Value Added Tax (VAT) is a multistage sales tax that is collected at each stage of the production and distribution process. A firm typically pays a fixed percent of the value it adds to the goods and services it purchases from other firms. For example, if a firm purchases $60 worth of raw materials from other firms and produces a good or service that sells for $100, the firm's value added is $40. If the VAT rate were five percent, the firm's VAT liability would be two dollars. A VAT that extends through the retail level would raise the same amount of revenue as a retail sales tax levied at the same rate. The United States does not have a value added tax, although most states have retail sales taxes.

Under a consumption type VAT, a firm pays VAT on its value added only, not on any purchases from other businesses. Because purchases of capital assets are not subject to the VAT, a consumption type VAT does not distort a firm's decision to employ capital or labor, nor does it distort an individual's decision to consume or save.

Under a subtraction method VAT, a firm's VAT tax liability is computed by subtracting its firm's purchases from other businesses from its sales to arrive at value added, and then applying the VAT rate. Under the credit invoice method, a firm's tax liability is determined by allowing the firm to credit the VAT paid on its purchases against the tax computed on its sales. In order to claim the credit, a firm would be required to furnish an invoice indicating the amount of VAT paid on the goods and services it purchased. The credit invoice method is less susceptible to noncompliance than the subtraction method, because the tendency of sellers to underreport sales and reduce taxes will be offset by the incentive of purchasers to report sales at their full price in order to receive full tax credits.

Under the destination principle, a good or service is considered to be taxed in the country where it is consumed so that imports and domestically-produced goods and services compete on an equal tax footing. In general, the appropriate VAT rate is applied to all imports, and a VAT rate of zero is applied at the export stage. Exporters are given full credit for any VAT paid on inputs purchased to produce a good or service. The method frees the good or service from any VAT imposed in an exporting country and subjects it to the same VAT rate as similar domestically-produced goods in the importing country.

To the extent that a VAT is imposed at a uniform rate across all goods and services, it will not distort an individual's decision about what goods and services to consume. For a variety of reasons, certain commodities, transactions, and/or firms may receive preferential treatment under a VAT. This may occur through either exemption or zero rating. Briefly, if a commodity or service is zero rated, it is freed of all value added tax. In other words, the good is taxed at a zero rate at every stage.

This may be contrasted with an exemption which frees the sale of a commodity or service from explicit payment of tax. The seller, however, does not receive a credit for VAT paid on his purchases. Explicit exemptions in S. 442 would be given to de minimis activities and for employee services furnished to an employer. Exemptions would also be defined implicitly by narrowly defining taxable transactions, e.g., by excluding sales of intangible property.

The proponents of a VAT argue that the tax is an efficient source of revenues in that it does not distort the present/future consumption choices of individuals, nor the choice among different consumption goods (if a uniform rate is applied). They also argue that any distortion in the labor/leisure choice is small relative to the intertemporal distortions caused by taxes such as the income tax.

Opponents argue that the VAT is a regressive tax, because consumption expenditures as a percentage of income decrease as income increases. Excluding necessities from the VAT, or reducing the VAT rate on necessities, may alleviate some of the regressivity but may substantially erode the VAT tax base and dilute the nondistortionary aspects of the tax. Adjusting transfer payments or providing a refundable income tax credit are often considered as alternatives to excluding or zero rating commodities.

Opponents of the VAT also argue that the VAT will result in a one time increase in the price level (if accommodated by the monetary authority), would distort the labor/leisure choice, and would compete with an important source of state and local revenues. In addition, the implementation of a credit invoice consumption type VAT would involve substantial administrative costs. Volume 3 of the Treasury Department's 1984 Report to the President, *Tax Reform for Fairness, Simplicity, and Economic Growth,* estimated that the Internal Revenue Service would require 18 months from the date of enactment to fully implement such a tax. It also estimated that the IRS would require an increase in personnel of 20,000 and an increased budget of $700 million annually to enforce a VAT.

S. 442

S. 442 would impose a VAT on the sale of property and the performance of services in the United States with respect to commercial transactions. The VAT would also be imposed on the sale or lease of real property and on the importation of property whether or not it is with respect to a commercial transaction. The amount of tax would be five percent of the value added to the property sold or the services performed and would be imposed on the seller at each stage of production and distribution, including the retail stage. S. 442 would require that all revenues net of administrative expenses be dedicated to deficit reduction and not used to finance current expenditures.

S. 442 has four important characteristics: (1) It is a consumption type VAT; (2) It uses the credit invoice method to calculate tax liability; (3) It uses the destination principle for border tax adjustments; and (4) It exempts or zero rates certain commodities.

Discussion

The Administration opposes S. 442. The Administration does not believe that tax increases are necessary to reduce the deficit. The value added tax, as its name states clearly, is an additional tax liability that would be paid by the American public. The Administration remains committed to reducing the deficit through reduced expenditures and continued economic growth.

EDUCATION SAVINGS BONDS: S. 353

Background

In the Technical and Miscellaneous Revenue Act of 1988, Congress enacted section 135 which excludes from income interest earned on qualified United States Series EE savings bonds to the extent the bond proceeds (principal and interest) are used to pay qualified higher educational expenses of the taxpayer or the taxpayer's spouse, child or dependent. Qualified Series EE bonds are those issued after December 31, 1989 to an individual who has attained age 24, and who is the sole owner of the bond, or who owns the bond jointly with his or her spouse. Subject to the phaseout rules, if the proceeds of all qualified Series EE bonds redeemed by the taxpayer during the taxable year are used to pay for qualified higher educational expenses, all interest accrued on such bonds is excluded from income. If a taxpayer uses a portion of the bond proceeds for purposes other than qualified higher educational expenses, i.e., if the bond proceeds exceed the student's qualified expenses, the amount of excludable interest is reduced on a pro rata basis.

Educational expenses that qualify for the tax exemption include tuition and fees required for the enrollment or attendance of a student at an eligible educational institution. These expenses are calculated net of scholarships, fellowships, and other tuition reduction amounts. Eligible educational institutions include most post-secondary institutions, including vocational schools, that meet the standards for participation in federal financial aid programs.

The benefits of this tax exemption are phased out for taxpayers filing joint returns and whose modified adjusted gross incomes are between $60,000 and $90,000 (adjusted for inflation after 1990). Thus, a taxpayer whose modified adjusted gross income exceeds $90,000 when the bonds are redeemed will not benefit from the exclusion. For single taxpayers and heads of households, the phase-out range is $40,000 to $55,000.

S. 353

S. 353 would allow a taxpayer to qualify for the interest exclusion provided by section 135 by paying for the educational expenses of any individual, including a person who is not a spouse or dependent of the taxpayer.

Discussion

The Administration opposes extension of the benefits provided in section 135 to taxpayers who are paying for the education expenses of an individual other than the taxpayer's spouse or dependent.

Section 135 is a modified version of a bill proposed by the previous Administration, entitled the "College Savings Bond Act of 1988." This Administration fully supports that initiative and generally supports the similar provision enacted by Congress in section 135. With the costs of a post-secondary education continuing to outpace inflation, American families need more than ever to save to educate their children. The current provision on education savings bonds provides valuable and needed assistance to low and moderate income American families in financing post-secondary education.

We are concerned that the purposes of the phase-out could be easily circumvented if the interest exclusion, and thus phase-out test, were made applicable to individuals other than the student, the student's spouse or a person who supports the student as a dependent within the meaning of section 151. Under the bill an individual could benefit from the exclusion even though the income of the student or the student's parents exceeds the phase-out limit. For example, high income parents could give tax-free monetary gifts to others (e.g., grandparents) with lower incomes for use in purchasing bonds to be used for the education of the parents' children. Congress enacted section 135 to enable low and moderate income families to save on a tax-free basis for their children's future education. We do not believe that it is appropriate to extend the benefits of this provision beyond that targeted group.

The estimated revenue loss from S. 353 would be as follows (in millions):

1989	1990	1991	1992	1993	1994	1995
0	-4	-19	-40	-60	-79	-96

CONCLUSION

This concludes my prepared remarks. I would be pleased to answer any questions.

PREPARED STATEMENT OF CHARLS E. WALKER

Mr. Chairman, I appreciate the invitation to appear before this committee to discuss the value added tax in general and Senator Hollings' proposal (S. 442) in particular. In presenting this testimony, I am speaking only for myself as an economist and former public official.

Senator Hollings is to be strongly commended for his proposal. Although I would differ with him on certain aspects of application—for example, I would favor a 5-percent, single-rate VAT applicable to all goods and services produced for profit—the important point is that the time has come for Congress and the President to consider adding this powerful revenue-raiser to the Federal tax arsenal. VATs attributes far outweigh its shortcomings.

Mr. Chairman, we need a VAT soon precisely because the Federal government is badly in need of revenue and the VAT is by far the best place to get it. The first priority for VAT funds is, as Senator Hollings emphasized, reduction in our huge, chronic Federal deficit. Beyond that, revenues are needed for selective and judicious reduction in the capital costs of investment in this country. Substantial revenues will be needed also because the nominal size of today's Federal deficit is much less than its true size—Social Security and other trust funds should be off-budget instead of on-budget, the savings and loan bailout funds should be on-budget, and certain other outlays in the nuclear, environmental and defense areas have been either understated or left out of the deficit calculation. In addition, some observers who favor much higher overall levels of social spending (I am not in that camp) argue that the deficit on that account comes to at least $100 billion per year. I shall leave the case for additional revenues for social spending to others. My prime concerns are the Federal deficit, which must be reduced, and our high capital costs. These two areas should be the main beneficiaries of a Federal VAT.

DEFICITS DO MATTER

The case for early and significant reduction in the Federal deficit is overriding.

- Interest on the public debt continues to mount. It tends to crowd out other Federal spending and the interest payments represent a transfer of real resources, an increasing amount of which goes abroad.
- Thanks to the skill and courage of Paul Volcker, Alan Greenspan, and their associates at the Federal Reserve, the deficits of recent years have not been excessively monetized. Heavy, continuing deficits, however, always carry this threat under our political system. Excessive monetization of the deficit could turn the current inflation rate, which is much too high, into the highly damaging double-digit variety we suffered a decade ago.

- Given the low rate of domestic saving in the U.S., our deficits have necessarily been financed to a considerable extent with foreign capital. This has led to a large and continuing trade deficit and the concomitant build-up of large foreign claims on the U.S. Such claims can be volatile when confidence in the U.S. wavers; they also have to be serviced, requiring a real transfer of resources abroad and an inevitable negative impact on the living standards of future generations. Politically, large and continuing trade deficits raise the pressure for protectionism in this country, foreign retaliation, and a resulting trade war that hurts everyone.
- The major long-run reason for dealing with the deficit is the paucity of domestic saving in the U.S. Our net national saving rate (individuals, businesses, and government) has averaged only 2.3 percent of GNP over the past three years, as contrasted with an average of 7.4 percent from 1960 to 1980, 10-to-12 percent in Western Europe, and 15 to 20 percent in Japan. Saving finances real investment and creates jobs, growth and competitiveness. Failure to raise the U.S. saving rate will ultimately doom this nation to second-class economic status.

Yes, Mr. Chairman, deficits do matter. They matter a great deal. It is time to deal with ours systematically and decisively.

CAPITAL COSTS

Mr. Chairman, Charts 1, 2 and 3 tell our capital cost story and tell it vividly. As is shown in Chart I, the research of the distinguished economist, John Shoven of Stanford, indicates that our capital costs are 29 percent higher than in West Germany, 59 percent higher than in the United Kingdom, and 105% higher than in Japan. High capital costs impede investment because they raise the "hurdle rate" that new investment projects must meet before businesses will undertake them. Our investment rate is already falling behind other industrial nations. It will lag further if we don't get our capital costs under control.

Chart 2 shows that our tax policy of the past seven years is a major culprit in the capital cost picture. The Economic Recovery Tax Act of 1981 cut taxes on capital gains (an important factor in capital costs), lowered other taxes on individual saving, such as with the Individual Retirement Account, and created one of the best business capital cost recovery system in the industrialized world. As a result, the cost of capital for equipment used in manufacturing—key to our competitiveness—dropped by almost 10 percent. But the Tax Equity and Fiscal Responsibility Act of 1982, which cut back sharply on accelerated depreciation, raised capital costs on equipment by almost nine percent. The Tax Reform Act of 1986, which repealed the ITC, slowed depreciation, cut back on IRA's, sharply raised taxes on capital gains, and raised the capital costs for equipment investment by almost 13 percent. Over the period 1981–1986 as a whole, as shown by the final bar in Chart 2, the cost of equipment capital rose by almost 23 percent.

One other damaging aspect of high capital costs should be mentioned namely, their tendency to tempt businesses to concentrate on short- rather than long-term investment projects. The higher the cost of capital to the firm, the higher the hurdle rate, an internally set level of return which new investment projects are required to meet, or else the company will not undertake them. Since "time is money," higher capital costs mean that short-term projects will be favored over those of longer duration, despite the fact that longer-term projects may add the most to productivity.

Chart 3 shows what tax policy has done to the cost of investment in equipment in another way—by picturing the changes in effective tax rates on such equipment. Before 1981, that rate was just above 28 percent; in effect, the ITC and the ADR depreciation system were the major factors bringing down the rate on new equipment from the general 46 percent corporate rate to 28.3 percent. ERTA in effect provided "expensing" for equipment, at least in present value (but not in cash-flow) terms. In other words, the combination of the ITC and accelerated depreciation under the Accelerated Cost Recovery System (also known as the legislative version of "10-5-3") in effect eliminated all taxes on business investment in new equipment. That direct exemption of equipment (and other business assets) is of course a hallmark of the consumption-type VAT. The 1981 tax legislation in effect moved our business income tax system, so far as equipment was concerned, far in the direction of a true consumption tax.

We must begin to move back in that direction. Therefore, when and if a VAT is enacted, Congress should give serious consideration to using part of the proceeds to reduce the capital cost of investing in equipment. For example, if the revenue from one point from the VAT I propose ($25 billion in 1991) were used to establish a targeted and highly effective investment tax credit, the user cost of capital for equipment (which includes economic depreciation) could be cut by perhaps 15 to 20 percent. That would mean a great deal to our efforts to remain competitive in the international economic sweepstakes.

FEDERAL DEFICIT REDUCTION GOALS

A strong case can be made for rejecting mere balance as the budget goal and striving instead for an annual surplus of about one percent of GNP. As Uncle Sam becomes a net lender and retires securities, rather than selling more, credit markets will strengthen and pressures on interest rates will decline. Since our large Federal deficit is strongly expansive to the economy, the Federal Reserve is forced to follow a stingier-than-otherwise monetary policy in order to offset the fiscal expansiveness. A surplus in the budget would give the Federal Reserve much more flexibility in managing monetary policy.

Realization of an annual surplus in the Federal budget would, other things equal, bolster our low domestic saving rate. Our trade position would tend to strengthen, perhaps moving into surplus. In addition, the goal of a one percent surplus could replace the balanced budget as the benchmark of fiscal responsibility for the administration and Congress.

ACHIEVING THE GOAL OF DEFICIT REDUCTION

While spending restraint should be accorded first priority in deficit reduction, it is an inescapable fact that a swing of more than $200 billion per year in the net budget deficit—the minimum amount needed to produce a net surplus—is all but impossible without a significant tax increase. The only alternatives are either decimation of the defense budget, or sharp (and politically undoable) cuts in Social Security and Medicare. From a political standpoint, a workable approach might be a five-year budget plan that would split the deficit reduction task between spending restraint and tax increases, or upwards of $100 billion per year for each. Spending goals would be met by slowing the rate of increase in Federal spending relative to potential GNP. On the tax side, new sources of revenue will have to be sought.

DEFICIT REDUCTION AND THE CURRENT TAX SYSTEM

User taxes, excise taxes, and tariffs do not possess a sturdy enough base to afford upwards of $100 billion in new revenues per year. Higher gasoline taxes would encounter strong political opposition; other energy taxes could impair U.S. industrial competitiveness. For big revenues, the choice is between the income tax or some new tax. The income tax is not well suited for the task at hand, economically or politically.

First, such a step would require hefty increases in income tax rates, thus violating the "tax compact" agreed to as part of the Tax Reform Act of 1986. Second, an income tax increase would have to impinge heavily on the middle class to raise sufficient revenue. The political strength of the middle class makes it very doubtful that any such tax increase could pass Congress. Third, increases in income taxes are inefficient in that significant amounts of taxable income flow through the underground economy and are unreported.

Fourth, the basic policy goal of deficit reduction is to raise domestic saving, but the fact is that income taxes hit saving more than once—once when income is earned, either by an individual or a business, and again when the invested savings produce a return. A third layer exists for corporate income received by shareholders in the form of dividends or capital gains because the income has already been taxed at the corporate level. Thus higher income taxes, especially those on upper-income individuals and on businesses, would deter the very saving and investment that the deficit reduction policy is designed to encourage. To the extent raising the saving rate is the goal of deficit reduction, tax increases which discourage private saving rather than consumption are the fiscal equivalent of running in place.

THE CASE FOR A VAT

VAT has several advantages over other types of taxes. It is a powerful revenue raiser; broadly applied, VAT would afford $25 billion in revenues per point by 1991. Surveys show that the sales tax (and VAT is a sales tax) is the "least unpopular" tax, the tax people prefer to pay if they must pay more. Participants in the underground economy would be hit by a VAT. Recent academic studies indicate that the U.S. saving rate and capital stock would grow much faster if a VAT were substituted for part or all of the income tax. As already noted, to the extent VAT revenues are used to reduce the multiple taxation of savings invested in productive equipment, the capital cost of that investment will decline significantly and U.S. competitiveness will strengthen.

A VAT is also more consistent with tax systems used by our trading partners around the world. Forty-seven countries now have a VAT and Canada has announced one—the U.S. is the last holdout among major nations. And the VAT can be structured so as to hit consumption primarily rather than the saving and investment that deficit reduction is supposed to encourage.

VAT AND ITS CRITICS

Critics of a VAT maintain that it is——

—*regressive,* hitting low-income people, who spend most of their funds on necessities of life, much harder than high-income people, who save more of their income;

—*inflationary,* directly contributing to an increase in the price level, and insidiously hidden from public view;

—*excessively complex,* thus requiring startup time of up to two years and big additions to IRS budgets and staff;

—*repugnant to State and local officials,* who view any type of Federal sales tax as an invasion of their own tax turf; and

—a *"money machine,"* which politicians will use as a means of funding an ever-larger Federal government.

These criticisms are, by and large, well taken, but they can be dealt with. The most important single requirement for that purpose would be for Congress *to enact a single-rate VAT applicable to all goods and services produced for profit*—i.e., all businesses and individuals who now pay Federal taxes on their taxable business or professional income would be hit. Assuming a single rate—admittedly a difficult political achievement, VAT could be administered through a simple "subtraction system" rather than the more complex "invoice-credit method" used by almost all other nations which have a VAT.

The simple subtraction method for levying VAT would require only a few lines to be added to the great majority of business and professional tax returns. One line would show total sales or fees, the second would reflect total purchases from other firms, and the third—the difference between the two—is value added, or the tax base. (Financial intermediaries would have to be given somewhat different and admittedly more complex treatment.) Audit of VAT payments could be a relatively simple system—in reality a slight expansion of our current Federal tax system—and it could be established in a short time. Budget and staffing requirements should not be excessive.

The major advantage of the invoice-credit method—which focuses on the goods and services produced rather than the businesses that produce them—is that it permits the multiple rates and/or exemptions which Western European nations in particular have resorted to in order to reduce the alleged regressivity of their VATs. But that's not really an advantage, for it's precisely where the excess complexity of a VAT arises. Regressivity can and should be dealt with by providing a refundable income tax credit to low-income Americans, an approach recommended by most economists and similar to those used in several states to reduce the regressivity of retail sales taxes. For example, if the basic level of spending on necessities for a family of four is $12,000 per year, the expected price level impact of a five-percent VAT on that family ($600) would be precisely offset by a $150 refundable credit for each family member. The refundable tax credit works well in the seven states that now use it. Moreover, refundable credits have existed in the Federal tax system for some time, earlier as credits on energy investment, more recently with respect to the earned income credit. (The system could be set up to provide refunds in advance to needy families.)

CONCERNS OF STATE AND LOCAL OFFICIALS

Objections of State and local officials to VAT appear to be based primarily on two perceptions: one valid and one invalid. The valid objection is that a Federal invoice-credit VAT, tied to individual transactions in goods and services, would sooner or later result in all states having to shift their retail sales tax systems to the Federal base. This is because the coverage of goods and services in retail sales taxes varies widely, and their businesses would resent having to levy and remit on two excise tax systems. Quite clearly, the subtraction system would avoid this problem, since it is tied *to taxpaying businesses and professional or service firms* rather than to the transactions in goods and services per se.

A second State and local perception, which apparently results from misunderstanding of VAT, reflects the fear that under VAT the full tax remittance burden would rise to the retail level. A Texas legislator told me recently he would not support a Federal VAT of five percent since it would, when combined with the maximum eight percent sales tax in that state, result in a "total burden" at the retail level of 13 percent. Other states with high retail sales taxes would face similar problems, or so they believe.

Since a VAT is a net tax at each stage of producing and marketing, including retailing, there is no such cumulative effect. VAT is in effect remitted by all businesses, and is therefore spread across a broad spectrum of tax payers with no special concentration at the retail level. Under VAT, retailers will pay only on their own value added, which is not large (in most industries) relative to the total prices of goods.

Moreoever, states might find the Federal VAT to be a blessing in disguise. If permitted to set up their own VATS and "piggyback" on the Federal VAT, as they should be, Uncle Sam would collect the additional tax and rebate it to the states at no cost. States would save considerably on administrative costs of collecting tax revenues. This would especially be the case if they were to abolish their retail sales taxes by in effect shifting them to the Federal VAT. In addition, a state VAT with a refundable tax credit would be much fairer than a state retail sales taxes without a refundable credit. Services would be taxed, thus broadening the tax base and reducing services' relative advantage compared to goods. Finally, some states with relatively high marginal income tax rates might find it desirable to use proceeds of a state VAT to cut back those rates.

A Federal VAT which includes "piggybacking" could therefore facilitate the development of fairer and more effective tax systems for state governments.

HIDDEN AND INFLATIONARY?

The charges that a VAT is both hidden and inflationary are easy to answer. Countries that rely on the VAT make no secret of the tax; in fact, tourists are repeatedly told that they should claim their VAT refunds on goods taken out of the country. To remind U.S. citizens of the presence of the VAT, the law could require the amount of tax to be clearly set forth in connection with the sale of any product or service.

As to the inflationary impact of a VAT, any such general price increase (if permitted to occur by the authorities who control the money supply) will be a once-and-for-all event. If, as is very desirable, the VAT is phased in over a three-to-five year period, the impact in any year will be small.

Some who favor an increase in income tax rates for deficit control argue that such a step would avoid the price increase involved in a VAT. This misses the fundamental point of taxes on people: the impact of their ability to buy goods and services. A sales tax, such as a VAT, reduces peoples' purchasing power *at* the store, in the form of a higher prices. An individual income tax takes the purchasing power away from the people *before they go to the store,* by reducing disposable income. Assuming tax increases of the same size, the impact on individuals' purchasing power and living standards is the same.

VAT AS A MONEY MACHINE

Conservatives, including myself, fear that a five percent VAT enacted in the near future will rise to 10 percent and higher as pressures mount within the public for ever-rising Federal spending. The only sure way to deal with this problem, which is seemingly inherent in our democracy is to enact as part of the VAT legislation a Constitutional amendment limiting the VAT to the original level, or perhaps permitting its increase only on the vote of a super-majority, such as three-fourths of the membership of each house of Congress. I would also argue that it would be well to accompany any such VAT amendment with other fiscal amendments that would help limit increases in Federal spending in our democracy to a sustainable, noninflationary level.

POLITICAL PROBLEMS

Who will take the lead in obtaining a Federal VAT? How can it be limited to a single rate applicable to all business and professional taxpayers? How can the Constitutional amendment necessary to deal with the money machine argument be assured? These are tough political questions.

It seems to me that the answer lies in the fact that VAT is a solution in search of a leader, and that that leader can only be a president of the United States—VAT is too radical for Congress alone to get far out front. Since presidential leadership is crucial to VAT, that president would be justified in making two non-negotiable demands as part of his price for leading so worthy a cause.

First, the president should state to Congress and the public that he will not accept the legislation establishing VAT unless the tax is a single rate applied to all individuals and businesses that now file Federal business and professional service tax returns. Second, the president should promise a veto of the bill if it is not accompanied by a Constitutional amendment, approved by Congress and ready for the states to ratify, that either caps the VAT at its original level or provides for an increase only on the approval of a substantial super-majority in Congress.

If VAT is indeed a solution in search of a leader, it can also be thought of as an idea whose time is getting closer and closer. It is at the very core of the answer to this nation's huge and dangerous fiscal problem. The sooner VAT gets here, the better for all of us.

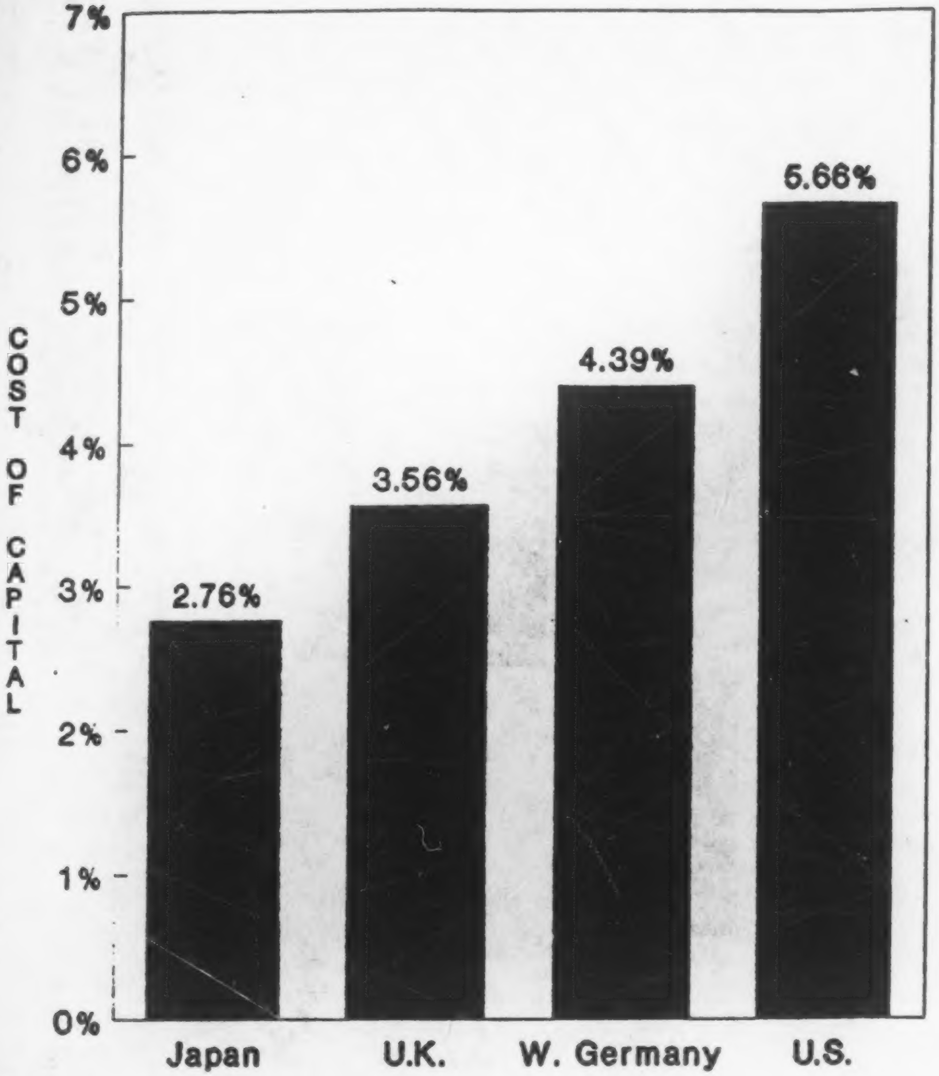
CONCLUSION

Mr. Chairman, as you can see, my differences with Senator Hollings are not truly substantive, and are offered as appropriate means for improving his legislation and broadening its positive economic effects. First, I would permit no exemptions and exceptions, but apply the single-rate tax to all goods and services produced for profit (as defined in the Federal tax code).

This would, of course, significantly increase the revenues generated by the tax. Second, I would levy the tax through the simple subtraction method rather than the more complex invoice-credit system. Third and finally, I would designate a significant, but not large portion of the proceeds of the tax to be used to cut the capital costs of investment in productive equipment, thereby adding to future competitiveness of the U.S. economy.

Thank you for the opportunity of testifying today.

Chart 1: International Comparisons of the Cost of Capital[1]

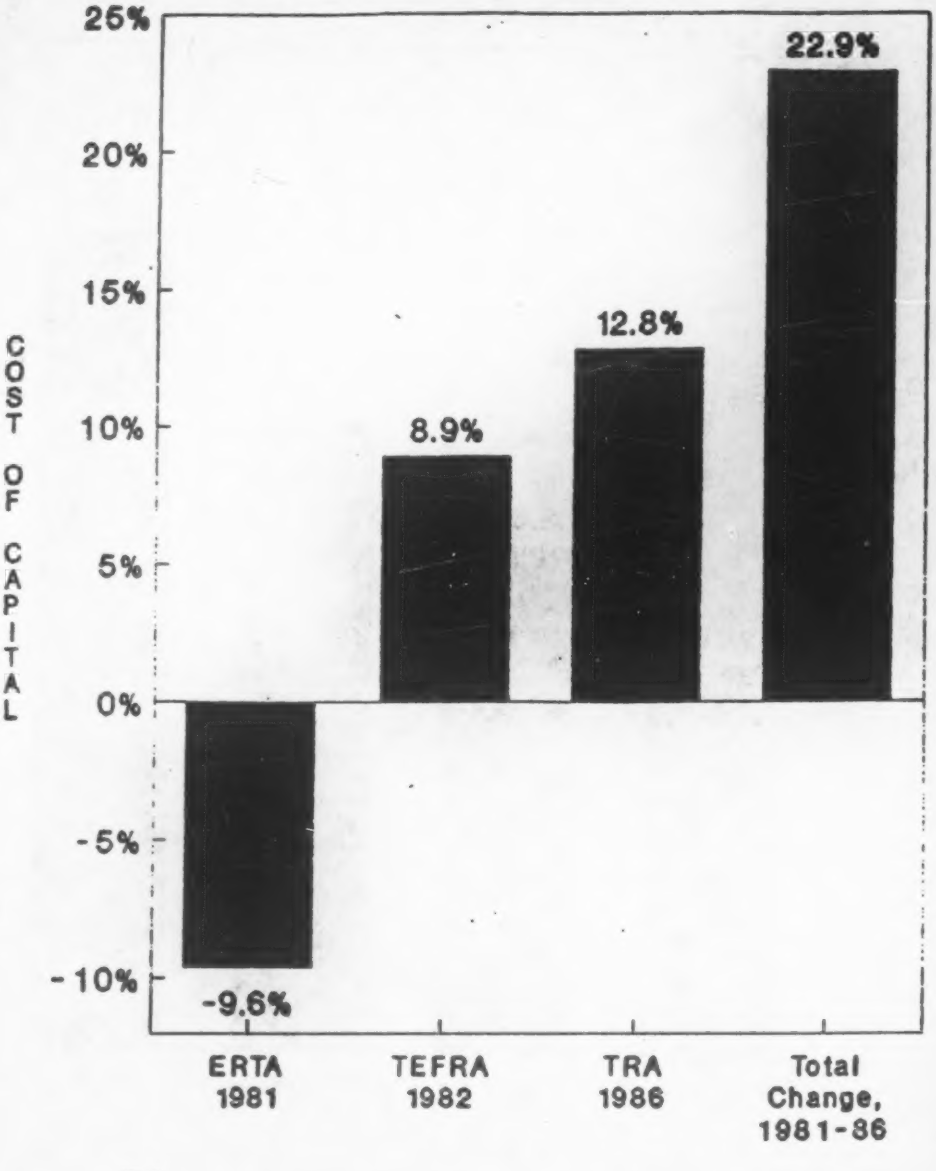


[1] Cost of capital for an average of debt and equity funds. The cost of capital measure used here is net of economic depreciation.

Source: John B. Shoven, "Taxation and the Cost of Capital: An International Comparison," in The Consumption Tax: A Better Alternative?, edited by Charls E. Walker and Mark A. Bloomfield, Ballinger Publishing Company, Cambridge Mass. 1987

Prepared by the American Council for Capital Formation

Chart 2: Impact of U.S. Tax Code Revisions on the Cost of Capital for Equipment Used in Manufacturing[1]



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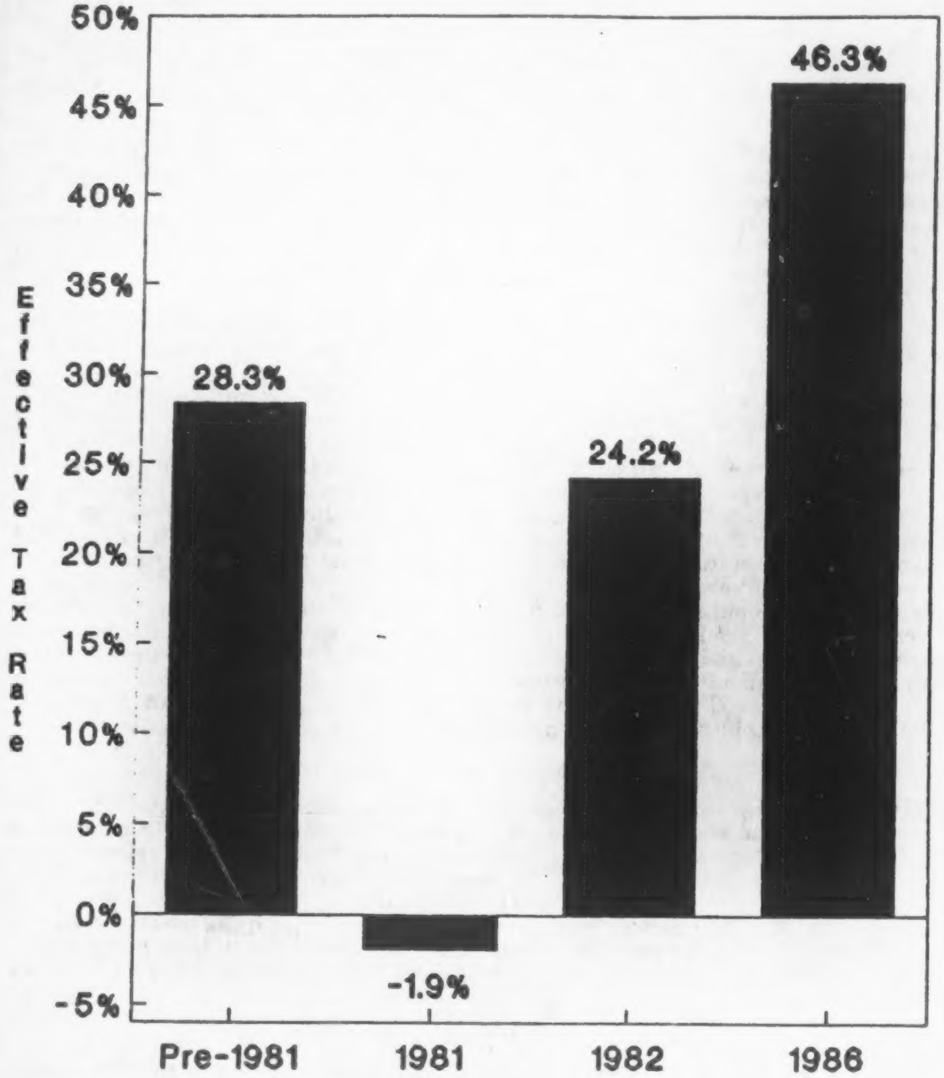
[1] The capital measure used here is the user cost which includes economic depreciation.

Source: Congressional Research Service, Library of Congress "Effects of Alternative Tax Regimes on the Cost of Capital for Selected Types of Equipment," Feb 1988 (unpublished)

Prepared by the American Council for Capital Formation

Chart 3: Effective Tax Rates on Equipment Used in Manufacturing



Source: Congressional Research Service, Library of Congress "Effects of Alternative Tax Regimes on the Cost of Capital for Selected Types of Equipment," Feb 1989 (unpublished)

Prepared by the American Council for Capital Formation

COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION, ON S. 659, S.838, AND S. 849 FOR REPEAL OF IRC SEC. 2063(c)

The American Bankers Association appreciates this opportunity to present the views of the banking industry on Section 2036(c) of the Internal Revenue Code. The American Bankers Association is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are about 95 percent of the industry total.

A. INTRODUCTION

IRC Sec. 2036(c) (hereinafter referred to as the "Statute") was enacted in 1987 and was significantly revised in 1988. The Statute is captioned "Inclusion Related to Valuation Freezes" and requires the inclusion of certain transferred property in a decedent's gross estate. As originally enacted, the Statute was controversial. Its revision has not lessened, but rather increased, the controversy.

No tax legislation relating to decedents' estates in the last 40 years, other than carryover basis, has evoked such broad-based criticism in terms of substance. One article has referred to the Statute as "Frankenstein's Monster." Dees, Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sells, Options, Employment Contracts and Leases, 66 Taxes, *The Tax Magazine,* 876 (1988). Also, the Statute takes a back seat to no subject in illustrating how the tax process should not work.

Our member banks and trust companies are interested in the Statute because their employees render estate planning advice to customers (including owners of small businesses) and the uncertainties created by the Statute make fulfilling this responsibility difficult if not impossible.

Three bills, S. 659 introduced by Senator Symms, S. 838 introduced by Senator Heflin and S. 849 introduced by Senator Daschle, would repeal the Statute.

B. PURPOSE OF ORIGINAL STATUTE

The legislative history makes clear that the Statute was aimed at so-called "estate freezes" where an equity interest in a corporation or partnership is transferred to or for a younger generation family member by a family member who retains a preferred interest in the same entity. The reason for the change was a belief that the transferred equity interests were being undervalued. If restricted in scope to these types of transfers, the Statute would have been criticized as being overly broad and not properly focused because the abuses could (and should) have been addressed by simple changes in valuation rules, but would not have engendered the hue and cry that has occurred.

C. CONCERNS REGARDING ORIGINAL STATUTE

The words of the Statute were so general that shortly after enactment concerns arose as to whether it would be interpreted to cover other factual situations which were not considered "estate freezes," as that term was generally understood. The key term "enterprise" was undefined. The legislative history did attempt to give the word meaning. The first definition, in the House Committee Report, was a "business conducted in any form whether it be through a corporation, partnership or proprietorship." This definition, if placed in the Statute, would have been satisfactory. However, the Conference Report broadened the definition by stating "an enterprise includes a business or other property which may produce income or gain." Since any property may produce income or gain, this definition is both unsatisfactory and meaningless. The most criticized aspect of the Statute was (1) its failure to define "enterprise" and (2) to do so in a way that does not broaden the scope of the Statute beyond its original purpose. Nevertheless, this criticism was not met in revising the Statute.

D. INCREASED CONCERNS REGARDING FENDED STATUTE

The initial concerns have been heightened by amending the Statute to grant authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection." Since, except as mentioned above, the "purposes" of the Statute have not been clearly stated, this is an unacceptable approach to tax legislation. In the affected area the approach is the equivalent of an income tax statute saying a tax shall be imposed on a taxpayer's net income "as defined by regulations." The IRS has, to date, not been neutral in applying the tax law in the estate freeze area, but rather has been taking very aggressive positions in attempting to expand *Dickman* v. *Comm'r*, 465 U.S. 330 (1984). See letter rulings 8723007 and 8726005. Such positions do not inspire confidence that it will be even- handed with the Statute. Fears on this point have been heightened by recent developments.

The intention of the IRS to give an expansive meaning to the term "enterprise" has been made apparent by speeches and statements of IRS personnel working on a release which will interpret the Statute. To illustrate, serious consideration has been given to treating life insurance (other than term insurance) as an enterprise. Such a position should have been rejected out of hand. Also, the statement has been made that the term will be interpreted to address an area of abuse which is described as "the transfer of wealth within families that is not taxed." Tax Notes, March 13, 1989, p. 1297. Where does the legislative history support this conclusion? Such statements indicate why there is serious concern with the broad grant of regulatory authority to the IRS in interpreting the Statute.

Another concrete example of this concern exists. The structure of the Statute is clear in requiring that the enterprise exist before the transfer is made that causes the Statute to apply. This interpretation is supported by the fact that an amendment made by the House Bill which would have changed this result was rejected and is not a part of the Statute. Nevertheless, statements made by IRS personnel indicate that the Statute will be interpreted as if the House proposal were enacted.

E. BROADENED SCOPE OF AMENDED STATUTE

Other changes in the Statute make clear that its uncertain scope is considerably broader than what was commonly understood as its purpose when enacted. An illustration in the family business area is the expansion to cover buy-sell agreements among shareholders of a company. The legislative history to the Statute, as originally enacted, indicated such agreements were not subject to the Statute in stating:

> The provision only makes certain property includable in the estate; it does not affect the valuation of such property for estate tax purposes.

The amended statute has overturned a body of case law that has developed over more than fifty years regarding the circumstances under which the sale price received by a decedent's estate will be accepted for federal estate tax purposes to. To prohibit the effectiveness of formula prices (other than one based upon fair market value) among family members while accepting such prices in buy-sell agreements between non-related parties makes it harder for family businesses to survive through more than one generation. A second illustration of the broadened scope of the Statute is its application to certain types of trusts, including grantor retained income trusts and possibly insurance trusts and credit shelter trusts, which do not involve business interests. Many other examples of the expanded scope of the Statute may be given.

F. OTHER UNCERTAINTIES

Terms in the Statute, other than "enterprise," present substantial problems of interpretation, including "in effect transfers" and "disproportionately large share of the potential appreciation." The latter term is explained in a footnote from the House Committee Report as follows:

> This standard may be understood by comparing two proportions. The first is the potential appreciation attributable to the transferred property divided by the value of such property. The second is the potential appreciation attributable to the retained interest divided by the value of that interest. If the first proportion exceeds the second, the disproportionate appreciation test is met.

We find this definition incomprehensible. How is "potential appreciation" to be determined? No indication is given in the legislative history as to what "in effect transfers" means. Also, the rule in IRC Sec. 2036(c) that spouses are to be treated as one person is uncertain in meaning as applied to common types of estate planning arrangements.

G. EFFECT ON SMALL BUSINESS

Even if the Statute is limited in scope to "business assets," as those words are commonly understood, serious problems are presented by its application. To illustrate, a demand loan by a parent to a corporation in which one or more of his children own stock causes the Statute to apply unless the cash loaned is "to be used to meet normal business needs" of the company. What do these words mean? Given the slow pace of regulation projects, five years is not an unreasonable estimate of how long it will be before regulations would be finalized on the meaning of these words. In the meantime, all demand loans will be suspect. Any agreement by the company to make payments to the parent for a period of more than three years causes the Statute to apply. It is not unusual for companies to continue term life insurance coverage for retired employees. Nevertheless, an agreement to do so, which could not be terminated, could cause the Statute to apply. Also, why should a distinction be made between agreements of more or less than three years when the distinction is meaningless because the parent controls the company and therefore can renew the agreement every three years? The payment of compensation which exceeds slightly an "arm's length" amount may cause the Statute to apply.

Many other illustrations may be given showing the fundamental unfairness of the Statute as applied to closely- held business interests. In short, the Statute represents an unwarranted intrusion into the affairs of small business. This result is difficult to understand bearing in mind the long history of Congress favoring such business.

H. SOLUTION

The American Bankers Association supports the repeal of the Statute. If the reasons for the enactment of the Statute require some statutory provision, the gift tax valuation rules could be amended to provide that transfers of equity interests to family members in a corporation or partnership by an individual holding a preferred interest shall be valued without giving effect to any rights in the preferred stock to vote or to convert the stock or to any other retained voting rights of the donor.

In his statement before the Finance Committee on May 17, 1989, Professor Harry L. Gutman rejected repealing the Statute and replacing it with a change in the valuation rules because such a change would not apply to what he refers to as "hard to detect" transfers which he asserts should be subjected to gift tax. He gives two illustrations of such transfers. One is a controlling shareholder who pays himself too small a salary and the second is a controlling shareholder who owns noncumulative preferred stock and passes a preferred dividend. A significant point is that the Statute does not deal with either of these situations. Thus, its retention does not change the result under current law. Another point is that the suggested change in the gift tax valuation rules would deal with the second of Professor Gutman's cases—the value of the preferred stock would be discounted greatly because of its non-cumulative feature and the assumed lack of control. Thus, any gift of common stock would produce an increased value for the stock when compared with its valuation under current law. The third point we would make is that many people disagree with Professor Gutman's assertion regarding a controlling shareholder making a gift to other common shareholders when he fails to pay himself the maximum salary he could be paid. Such a result would, in our opinion, be another example of the improper intrusion of the tax laws into the small business area. We also note that the example of the classic estate freeze which Professor Gutman referred to would be caught by the proposed change in the gift tax valuation rules because the 6% non-cumulative preferred stock of Newco would be valued without X being in control of that company. The result would be that its value would be substantially less than $6.9 million and a large taxable gift would have been made to X's two children upon a sale of the common stock for $1 million. Another significant point is that Professor Gutman's example may result in substantial gift tax liabilities for X under current law. A case which is essentially the same as his example is awaiting a decision by the Tax Court. *Elizabeth W. and Ritchie A. Snyder,* Docket Nos. 28964-87 and 28965-87.

Statement of the American Bar Association

Mr. Chairman and Members of the Subcommittee: I am L. Henry Gissel, Jr., Chairman of the Section of Real Property, Probate and Trust Law of the American Bar Association (the "ABA"), and I have been designated by Robert D. Raven, the President of the American Bar Association, to submit this testimony on behalf of the ABA.

At its most recent Annual Meeting, which was held last August, upon the recommendation of the ABA Sections of Taxation and Real Property, Probate and Trust Law, the House of Delegates of the ABA adopted resolutions recommending the repeal of Section 2036(c) of the Internal Revenue Code and making a plea for stability in the transfer tax area. Such resolutions now state the official policy of the ABA. The full resolutions and the reports supporting them are attached as Exhibits A and B, respectively, to this statement.

The ABA is grateful for the opportunity to present testimony to this distinguished Committee stating the views of our membership (which is composed of more than 300,000 lawyers) concerning the possible repeal of Section 2036(c). Once again we welcome the opportunity of working with the Congress to attempt to improve the law and serve the interest of the public.

SECTION 2036(C)—THE ANTI-FAMILY BUSINESS PROVISION; WHAT'S WRONG WITH IT AND WHY IT SHOULD BE REPEALED

Introduction and Background:

Section 2036(c) was added to the Internal Revenue Code by the Revenue Act of 1987 and substantially modified in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). It is a transfer tax (i.e. estate, gift and generation-skipping transfer tax) provision that appears to have been aimed initially at halting a business owner's perceived ability to transfer a disproportionate right to future appreciation in the value of a business without being subject to transfer taxes.

Under prior law, some business owners would make a gift of common stock, retain preferred stock, and claim that the preferred represented substantially all the value of the business at the time of gift. Assuming that the common stock would appreciate more than the preferred, the owner would attempt to "freeze" the transfer tax value of the owner's retained business interest at its value on the date of the disproportionate transfer. The principal concern that led to the proposal of Section 2036(c) was a fear that such business interests that were being transferred within a family were being undervalued for transfer tax purposes.

That concern could probably have been met by improved enforcement of existing rules. Instead, Section 2036(c) was enacted. As originally written the statute was dangerously overbroad and ambiguous, and aimed almost exclusively at family-owned businesses. TAMRA, instead of simplifying or explaining the statute, made it even broader in many respects, left it just as ambiguous, and made it harder to escape the statute's application once it is triggered.

Section 2036(c) hurts the family business by creating a potentially enormous penalty for gifts or sales within a family (in the form of a later transfer tax), thus making it more desirable to sell a business to a third party than to retain it in the family. Even if this were its only flaw, Section 2036(c) should be repealed.

Section 2036(c) may also be applied to many non-business transfers, including transfers to garden-variety trusts. This amounts to a radical revision to the transfer tax system, a change made by indirection and without legislative hearings. The legislative history gives no indication that Congress recognized the fundamental changes being made by this new provision with its "Alice in Wonderland" approach to transfer taxation, in which transfers "in effect" occur and individuals are taxed on property long after they have irrevocably severed all connection to it. Section 2036(c) represents the first time that the transfer taxes have diverged to this extent from property law concepts, the first time that sales for full fair market value give rise to transfer taxation and the first time that an interest of, or power held by, one spouse is deemed to belong to the other spouse for transfer tax purposes—perhaps even after death which is a bizarre concept in its own right.

Explanation:

Section 2036(c) is triggered if a "Disproportionate Transfer" is made.[1] Thereafter, any subsequent appreciation in the value of the transferred property is subject to

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[1] A Disproportionate Transfer occurs if a person who, together with his or her family "holds a substantial interest in an enterprise. in effect transfers after December 17, 1987, property

Continued

estate or gift tax (and in certain circumstances, to generation-skipping transfer tax). The amount of tax ultimately imposed is completely open-ended because it is based on appreciation in the property from the date of the original transfer to the date of a later event that triggers the tax (death of the original transferor, or, if earlier, certain other transfers by the transferor or the transferee). Moreover, this tax is imposed even where the appreciation was generated by the transferee's own efforts or other causes unrelated to the transferor. The tax rate can be as high as 55% (or 60%, if the 5% surtax is applicable). In addition, if generation-skipping transfer tax is triggered (because, for example, the Disproportionate Transfer was to a grandchild), the combined tax rate can be considerably higher (another 55% of what remains after paying the estate or gift tax).

An Example: [2]

Imagine a closely-held business owner who, upon approaching retirement, induces his son to run the family business by giving him all of the common stock in the business (worth $1 million). The owner retains dividend-paying preferred stock (also worth $1 million) that he intends to leave to his daughter, who does not work in the business. The owner pays gift tax on the $1 million gift to the son at the stock's fair market value, but is still required by Section 2036(c) to pay an additional tax on any subsequent increase in the value of the common stock (in which the owner has no interest). This occurs even if the appreciation is attributable entirely to the son's efforts (or to a decision to pay no dividends on the common stock).

Furthermore, if the owner later gives the preferred stock to his daughter before his death, all appreciation in the common stock from the initial transfer to the son to the date the preferred stock is given to the daughter will be subject to gift tax. If, for example, the common stock is worth $5 million when the owner dies (or gives the preferred stock to his daughter), there will be an estate or gift tax of more than $2 million on the $4 million growth in value of the common stock.[3] Because this tax is payable by the son out of the son's stock, if the son were willing to pay full value for the common stock he would be much better off buying an interest in another business than buying into his own family's business.

The Fatal Flaws:

There are numerous flaws in Section 2036(c), only some of which are described generally or illustrated above. For example,

(1) The statute is overbroad in its application to perfectly legitimate transactions. It discourages not only the types of transfers at which the statute appears to have been aimed (such as the transfer described in the above example), but also desirable day-to-day business transactions and family investment arrangements that contemplate no transfer tax avoidance. It does this by defining a Disproportionate Transfer so broadly and amorphously as to potentially include common business transactions such as a parent's loan, lease, sale, or provision of services to a business in which a child has an interest but the parent has no other interest. The statute may encompass common non-business investments like the creation of a family trust. Furthermore, the application of the statute to common business transactions is not limited to those occurring within a family. It could create large transfer tax penalties where unrelated business owners enter into a buy-sell agreement and agree to exclude key man insurance proceeds in valuing the business or where stock is sold to unrelated employees at a reduced price as part of the employees' compensation.

(2) The wording of Section 2036(c) (quoted in part in footnote 1) is imprecise and, at times, misleading. Moreover, TAMRA gives the Treasury Department unusually broad power to determine by regulations the extent to which this provision applies to non-business transactions. For example, the word "enterprise" is an essential element in the definition of property transfers affected by the statute, but it is not defined in the statute. The 1987 Conference Committee Report states that, "an enterprise includes a business or other property which may produce income or gain." If Treasury adopts a definition as broad as this anticipates, Section 2036(c) could reach

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having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining an interest in the income of, or rights in, the enterprise." For this purpose, the normal rule excepting sales for full consideration does not apply to sales among family members and, except as provided in regulations, spouses are treated as one person.

[2] This is the case which the statute was trying to deal with, but as the example illustrates, it is an extreme penalty imposed on closely-held businesses.

[3] If the son purchased the common stock and can prove that the consideration paid by him did not originate, directly or indirectly, from the owner, then the tax might be as low as $1 million or, if the wording of the statute takes precedence over the conflicting Conference Report, no tax would be due.

any appreciation that occurs following a transfer of cash, marketable securities, or insurance. Similarly, the statute provides that "except as provided by regulation" an individual and his or her spouse are to be treated as one person. This rule gives Treasury the right to determine the extent to which an individual will be taxed on property in which he or she has no interest merely because his or her spouse holds on interest in such property. This is a substantial departure from prior principles of transfer taxation. Furthermore, if this provision is interpreted to cause inclusion of property in the estate of the owner's spouse (as the TAMRA Conference Report indicates) if such spouse has any interest, it may have the practical effect of preventing all but the very wealthy from taking advantage of both spouses' unified estate and gift tax credits, because only the very wealthy have the wherewithal to avoid giving the surviving spouse any interest in the $600,000 owned by the first spouse to die. Such fundamental changes in tax policy should be made expressly by Congress, not by delegating authority to the authors of tax regulations.

(3) Section 2036(c) departs from general concepts of transfer taxation in other dramatic ways. By providing that fair market value sales between family members may nevertheless generate estate or gift tax liability, it imposes a tax even if no gratuitous transfer has occurred. In fact, it may generate estate or gift tax liability in that not uncommon situation of a child overpaying for an elderly parent's interest in a business because of a perceived need on the part of the child to obtain full control of the business. In addition, it subjects property to estate or gift tax with respect to an individual who no longer has any interest in, or power over, that property. If a gift tax is paid on the full value of a transfer, or if full value is paid for property so that no gift occurs, there simply is no abuse that justifies an additional transfer tax on any post-transfer appreciation in the property.

(4) Section 2036(c) applies to all Disproportionate Transfers, no matter how slight the disproportionality, and makes no differentiation between different forms of disproportionality. This is nonsensical and means that, for example, all of the appreciation on transferred common stock will be subject to tax in each of the following very different scenarios:

> (a) The 100% owner of a corporation with $1 million of common stock and $1 million of preferred stock, transfers the $1 million of common stock.
>
> (b) A 10% owner of a corporation with $1 million of common stock and $10,000 of preferred stock transfers the $1 million of common stock. Such a situation could arise where the 10% owner inherited the $10,000 of preferred stock when the recapitalization itself occurred in the prior generation.

(5) Section 2036(c) is an all-inclusive statute that carves out a small list of permitted business and family transactions ("safe harbors"). For example, a transfer of 100% of the stock in a corporation might nevertheless be considered a Disproportionate Transfer if the corporation owes money to the former owner or if the former owner has an employment contract with the corporation. The safe harbor in this situation provides that, if 12 specific "qualified debt" requirements or if three specific employment contract requirements are met, the transfer of the common stock will not be treated as disproportionate. A parent who loans money to a child's business or provides services for hire is unlikely to know enough to meet all requirements of the appropriate safe harbor. For example, unless a lawyer is consulted, the parent might easily make a loan with a term longer than the maximum permitted by the appropriate safe harbor. It is impractical to expect compliance and silly to suppose that the few, very narrow safe harbors will protect non-tax motivated business owners from the potentially enormous transfer tax penalty imposed by Section 2036(c).

(6) It appears that a major impetus for enactment of Section 2036(c) was the belief that successful freeze transactions stem from undervaluations of property by taxpayers. Congress apparently felt it was unrealistic to expect the Internal Revenue Service to successfully police valuation abuses at the gift tax level. As a result, Section 2036(c) imposes a structure by which gift tax undervaluations are unimportant because the property subject to gift tax will *also* be subject to a later transfer tax on its appreciated value. The problem with this "solution" is that even more valuations are necessary than before because for example, common stock must be valued at the time of the initial transfer and again at the time of every subsequent transfer of preferred stock (including at death). Therefore, the honest taxpayer is penalized by a structure that assumes undervaluations. Forcing more frequent valuations of property is not a solution to the perceived inability of the Internal Revenue Service to obtain proper valuations. Furthermore, valuing property in the future is no easier nor less susceptible to abuse than valuing it at the time of a prior gift.

(7) Section 2036(c) is unworkable and ineffective except as an *in terrorem* device to inhibit honest and well-informed taxpayers. Taxpayers and their advisers, uncertain about what actions will result in tax under Section 2036(c) and what will not, are refraining from a large number of perfectly legitimate transactions to the general harm of family-owned businesses. Some (perhaps with less knowledge) may pursue such transactions and trigger the statute but escape its consequences because of the Service's inability to police the numerous triggering events. This will create disrespect for the law and impair the self-assessment system.

AMERICAN BAR ASSOCIATION
REAL PROPERTY
PROBATE AND TRUST LAW SECTION

REPORT

TO THE HOUSE OF DELEGATES

RECOMMENDATION

BE IT RESOLVED, that the American Bar Association recommends to Congress that Subsection (c) (inclusion related to valuation freezes), as added by the Revenue Act of 1987, to Section 2036 of the Internal Revenue Code of 1986, be repealed.

REPORT

The Revenue Act of 1987, P.L. 100-203, signed into law by the President on December 22, 1987, added a new subsection (c) to Section 2036 of the Internal Revenue Code. To an extent not seen before in the federal estate and gift tax area, the language used in new Section 2036(c) is vague, overbroad and ambiguous. Virtually every word or phrase requires further definition. Moreover the few definitions that can be found in the legislative history are often as unhelpful as the statutory language.

The stated purpose of new Section 2036(c) was to eliminate "Valuation Freezes", that is, the transfer of the future appreciation in certain assets without giving up the enjoyment of the assets. The only official description of the "abuse" that was sought to be curbed by this new subsection is contained in the House Ways and Means Committee report (the "House Report") to H. R. 3545 ("the House Bill"), which contained the provision that eventually evolved in to S2036(c).

More Detailed Explanation

In order to illustrate the immense problems with Section 2036(c), a partial list of the provision's uncertainties and potential harsh results follows.

1. The Substantial Interest requirement.

Section 2036(c) contains a threshold test for its applicability, namely that it applies only if a "person holds a substantial interest in an enterprise." However, nowhere in Section 2036 or its legislative history is it conclusively stated when this test is to be applied.

A substantial interest is defined statutorily as 10 percent or more of the "voting power" or "income stream", or both, held "directly or indirectly". None of these terms are defined in the statute or legislative history. It is not clear whether the right to vote held purely in a fiduciary capacity constitutes "voting power". It is not clear whether the phrase "income stream" looks only to actual income of the enterprise; and if so over what period of time; or whether rights to "potential" income are to be included. Nor is it clear how "income" for purposes of determining the "income stream" that a person "owns" is to be determined. The questions are infinite.

2. Definition of "Enterprise".

Section 2036(c) uses the term "enterprise" in defining the type of ownership interest subject to the statute. The term is not, however, defined in the statute. In the Conference Committee Report, the following is stated: "Under the Conference Agreement, an enterprise includes a business or other property which may produce income or gain." (Emphasis added.) If the phrase "other property" is not read to refer to "other similar property," the term enterprise could encompass any form of property, including vacant real estate, and possibly "cash", making it much broader than its commonly understood meaning.

3. Applicability of Section 2036(c) to Start-up Situations.

One of the fundamental uncertainties with respect to the threshold test and the definition of the term "enterprise," is the extent to which Section 2036(c) applies to the creation of an enterprise by members of the same family. For example, it is unclear whether Section 2036(c) applies where a parent and child together form a corporation, each contributing cash, and parent receives preferred stock (reflecting his or her cash contribution) and child receives common stock reflecting his or her cash contribution. If the threshold test is met, parent's purchase of preferred stock while child purchases common stock could arguably be the type of "in effect" transfer that runs afoul of the disproportionality test discussed below. Child's payment in full for the common stock would not prevent the application of Section 2036(c) because of the special rule for sales to family members discussed below.

4. The Disproportionality Test.

The crux of Section 2036(c) is the disproportionality test, referred to above. It provides that Section 2036(c) is triggered where a person who holds a substantial interest in an enterprise

> "in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise...".

This language leaves ambiguous two inter-related fundamental aspects of the disproportionality test. First, it is unclear what comparison is to be made to determine whether the potential appreciation transferred or the income or other rights retained is "disproportionately large." Second, the statute fails to specify when the transferor's initial shares are to be determined. To determine whether something is disproportionate, one must know both the items to be compared and the starting point of the comparison. The statute provides neither.

5. Meaning of "Share in the Income of... the Enterprise".

A transaction is subject to the statute if a targeted transfer is made "while retaining a disproportionately large share in the income of... the enterprise..." No guidance is given, other than the ordinary meaning of the word, "income" as to what constitutes the "income of [an] enterprise." It has been suggested that salary and interest payments may fit within the definition. Nor is guidance given concerning how the rights to income held by different types of interests are to be compared. For example, how does one determine what share of the income of an enterprise is represented by common stock in a profitable corporation that has never paid a dividend? Similarly, in a corporation where preferred and common stock dividends have traditionally been paid and a higher dividend had been paid on the common stock, does the preferred stock, due to its preference, represent a greater share of income? Again the questions are infinite.

6. Sale to Family Members.

Section 2036(c) contains a special rule for sales to family members, by providing that the

> "...exception contained in [Section 2036](a) for a bona fide sale shall not apply to a transfer described in [Section 2036(c)](1) if such transfer is to a member of the transferor's family."

Under the provisions of Section 2036 prior to the 1987 amendment, a sale of property with retention of an income or other interest in the property, could cause the transferred property to be includible in the transferor's estate, unless the transfer was a "bona fide sale for an adequate and full consideration in money or money's worth." Section 2036(a).

The new subsection provides that, in the case of intrafamily transfers, the property in question is includible in the transferor's estate *if it falls within Section 2036(c)*, even if there was a bona fide sale for a full and adequate consideration. Thus the estate tax (which is to be imposed only on "transfers") is made applicable where there is no gift or transfer of value. This provision is inconsistent with the application of Section 2036(a) in situations to which Section 2036(c) does not apply, and indeed to the entire application of the estate tax which, in all other respects, taxes only transfers for less than full and adequate consideration in money or money's worth.

If consideration is received for the transfer, the Conference Report states that "the amount included in the estate" (of the decedent transferor *e.g.*, the parent) "will be reduced by the value of the consideration received by the decedent" (on account of that post 12/17/87 transfer of appreciation property in the enterprise). The wording of this "consideration offset" (which seems clearly enough described in the Conference Report) is *not* at all clear in the actual wording of the statute, which *says* "in lieu of applying section 2043, appropriate adjustments shall be made for the value of the retained interest" (perhaps meaning the combination of what is retained and deemed retained in the enterprise). It is unclear how the adjustment will be made and how the various interests will be valued.

Transactions among family members must now be made at their peril, no matter what the motivation for such transaction may be. This provision induces a business owner to sell to outsiders rather than to family members.

7. Transfers of Section 2036(c) Retained Interests.

As written, Section 2036(c) confirms that the transfer of a retained interest as described by Section 2036(c) is treated as a transfer of an interest in the transferred property for purposes of the three year rule of Section 2035. The Technical Corrections Bill introduced on March 31, 1988, would replace this provision with a gift tax provision.

The proposed amendment to Section 2036(c) provides that the lifetime transfer of a retained interest described in Section 2036(c) shall be treated as a "transfer by gift" of the previously transferred property and that the transfer by the original transferee of the transferred property described in Section 2036(c) during the life of the original transferor, to a non-family member constitutes a "transfer by gift" of the previously transferred property by the original transferor. This proposed amendment has several serious technical problems of its own.

The amendment as written would impose multiple gift taxes on the same transfer, without any credit for prior gift tax paid or payable, and treat all such transfers as "adjusted taxable gifts." Consider the following example: Father gives common stock in X Corp. to Daughter while retaining preferred stock. Five years later Father and Daughter, as part of a sale of 100% of X Corp., sell their entire interests to Y Corp. for cash. Under the amendment, the sale by Father of his preferred stock to Y Corp. would trigger a second "transfer by gift" of the common stock previously given from Father to Daughter and the sale by Daughter of her common stock would arguably trigger a third "transfer by gift" of the same common stock. This surely could not have been intended. These problems are further compounded by the fact that if the daughter were instead Father's granddaughter, in addition to a gift tax, there could also be a generation-skipping transfer tax.

Conclusion

The extent and significance of the ambiguities suggest that each alone is not an isolated technicality to be resolved but rather that the statute itself is without theoretical foundation on which to build a legislative framework. Concepts of valuation, income, recognition of capital gains and imputation of service income are all folded into a provision incorporated in the excise tax on the transfer of property. The interpretative problems will create uncertainty and general unenforceability. In addition, the lack of charity effectively delegates to the Internal Revenue Service the ability to legislate.

It is submitted that the new Section 2036(c) of the Code is fatally flawed and amendments addressing its serious problems cannot be drafted and enacted quickly enough to prevent a disruption in family transactions. It is unfair to place all family transactions, many of which are not done for tax reasons, in jeopardy for a substantial period of time. Section 2036(c) should be repealed until the exceedingly complex problems that the statute presents are solved. The enactment of such statutes has the potential to demean the rule of law and place voluntary taxpayer compliance in jeopardy.

Respectfully submitted,

Anthony B. Kuklin

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AMERICAN BAR ASSOCIATION
REAL PROPERTY, PROBATE AND TRUST LAW SECTION

REPORT TO THE HOUSE OF DELEGATES

RESOLUTIONS

BE IT RESOLVED, that the American Bar Association urges Congress to recognize the necessity for stability in the federal transfer tax system and recommends to Congress in order to establish and maintain stability that:

1) Any proposed change in the federal transfer tax system be required to carry a heavy burden of persuasion both that the inequity or inefficiency of the current law is so great that further changes with their resultant disruptive effect are justified and that such changes will be a material improvement over the current law.

2) If any changes are to be made in the federal transfer tax system, they should be made through an orderly legislative process with participation of tax practitioners, including:

a) Hearings with adequate notice and an opportunity for tax practitioners to participate in the formulation of the new laws.

b) Bills circulated and reviewed fully before passage by the House.

c) Bills circulated and reviewed fully before passage by the Senate.

3) If any changes are to be made in the federal transfer tax system, they should be prospective only with a reasonable lead time (at least one year) for instruments to be amended to reflect such changes, and

4) Constant small changes should be avoided and no new provision should be enacted that is not both understandable by tax practitioners and administrable by the Internal Revenue Service.

REPORT

The federal transfer tax system, encompassing federal estate, gift and generation-skipping transfer taxes, affects a broad range of Americans, including owners of farms, ranches and other closely-held businesses and is an important consideration affecting the distribution of family assets accumulated over a lifetime. Significant and complex changes made in that system in nine tax bills in the last twelve years have been, in many cases, unproductive and costly and have resulted in great instability in the federal transfer tax system. Many of the changes have been neither understandable by tax practitioners nor administrable by the Internal Revenue Service.

This instability in the federal transfer tax system has made it extraordinarily difficult for many individuals subject to the transfer tax system to plan for the orderly disposition of their assets, while requiring them constantly to reconsider and revise their estate plans. In the case of owners of interests in closely-held businesses such planning is often essential to the survival of such enterprises. Given the importance to this country of the orderly transmission of private property, the federal transfer tax system should be understandable, have stability and be reasonably administrable.

There is a need for stability in the system and only changes that are essential should be made. Further, those changes should be made only with adequate notice and an opportunity for tax practitioners to participate in the formulation of the new laws.

Instability in the Federal Transfer Tax System

The federal transfer tax system has gone through so many significant changes in the last twelve years beginning with the passage of the Tax Reform Act of 1976, that it has become an area of great uncertainty, full of traps for even the most specialized practitioner. Clients have been required to reconsider their estate plans repeatedly and in many cases radically change them because of "reforms" made by the Tax Reform Act of 1976, the Technical Corrections Bill of 1977, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, the Retirement Equity Act of 1984, the Tax Reform Act of 1986, and the Omnibus Budget Reconciliation Act of 1987. Prior to 1976 there had been a significant time interval between major tax law changes. The 1954 Code was enacted 15 years after the 1939 Code, and the 1969 major tax revision came 15 years later. However, nine times in the last twelve years, taxpayer families in the middle wealth range of $600,000 or more, if conscientious and able to afford to do so, have had to review and, in many cases, revise their estate plans to avoid paying excessive transfer taxes on death. It is an unfair and unreasonable burden to taxpayers to make them reconsider or redo their estate plans almost annually.

Even more inequitable is the fact that many, if not most, taxpayers are unaware that their estate plans may no longer fulfill the goals they intended and reasonably expected to achieve when their wills were drafted or, worse, may now be subject to new unforeseen tax burdens. In most cases, it is only the very well-to-do taxpayer who can afford to have the continuing relationship with a lawyer that has become necessary to have his or her estate plan continually reviewed in an attempt to keep it up-to-date. For small business owners and families whose assets aggregate $600,000 to $2,000,000, the constant changes in the law have caused serious dislocation (which some call chaos) in the ordinary process of planning for one's inevitable death. Above all in this area of the law, taxpayers, their advisers, and the government need stability and a period without change.

Lack of Regulations Giving Guidance

It should be noted that instability in this area results not only from the passage of new legislation but also from the obvious incapacity of the Treasury and Internal Revenue Service to develop explanatory regulations to flesn out decisions made by Congress. In many instances this absence of regulatory guidelines exists in areas where substantial policy decision-making has been transferred from the legislative process to the regulatory process, with the result that even if taxpayers are alert enough to be aware of the fact that changes have been made in an area they will not know exactly what those changes may be when the process has been finalized. In the meantime, they are challenged to do their best to cope with the uncertainty involved. In many cases clients are being advised that their present wills or other transfer documents have been prepared on an interim basis and must be again reviewed when tax issues raised by those documents have been resolved. This uncertainty creates enormous (and unnecessary) frustrations for practitioners and their clients, which in turn undermines the client's

confidence in the transfer tax system. There are very real transaction costs of making changes in a tax system. These costs include training and retooling the government, taxpayers and their advisers being required to learn new tax rules and the implications of changes on commercial transactions both future and past. Such costs further detract from the productivity of American businesses.

Need for Stability and Understandability

A transfer tax system should be understandable, have stability and be reasonably administrable by the government. Estate planning advisers need to be given the opportunity to understand the current law and to keep credibility with their clients. Although income taxes need to be considered yearly, the arrangements that one makes for the disposition of property on death should not need to be reconsidered on an annual or even biannual basis. Furthermore, although a taxpayer who is adversely affected by a change in the income tax law can, in many cases, decide not to enter into a transaction, no one can decide not to die or not to be affected by a change in the estate tax law.

The American system of voluntary compliance with the system of taxation requires taxpayer confidence in the fairness and stability of the law and taxpayers will not have that confidence if they cannot rely and plan on a relatively constant set of assumptions.

The repeated recent piecemeal changes in the federal transfer tax system are undermining the confidence in the system and the rule of law by subjecting taxpayers to unreasonable and inconsistent application of new laws which taxpayers, practitioners and those administering the law are not given sufficient time to fully understand.

Respectfully submitted,

Anthony B. Kuklin

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

The American Petroleum Institute (API) submits this statement for the record of hearings of the Senate Finance Committee, regarding S. 442, to be held May 17, 1989. The API is a national trade association serving about 6,000 individual and over 200 corporate members engaged in all facets of the petroleum industry.

S. 442, introduced by Sen. Hollings (D-SC) would impose a value added tax and provide a trust fund in the Department of Treasury for deficit and debt reduction.

As early as 1982, API became concerned about the effect of the federal deficit on the economy and began to study ways to deal with the problem. Our members were convinced then—and remain convinced today—that the most efficient way to reduce the deficit is by controlling the growth of federal spending—not by raising new taxes.

We also, however, recognized that there might come a time when Congress and the Administration would decide it was necessary to raise significant revenues to deal with the deficit. After considerable analysis, API concluded that, if significant new taxes were to be raised, a consumption value-added tax would do the least harm to the economy.

We are not convinced that all efforts to reduce spending have been exhausted, and that tax increases are needed. However, we do believe that broader study and discussion of value added taxes as a revenue source for deficit reduction would be useful. In that regard, Senator Hollings' bill and this hearing are certainly timely, and we applaud Senator Hollings' efforts in furthering the debate. To contribute to that discussion, API wishes to submit this statement which discusses two VAT methods—the credit-invoice method and the subtraction method—and explains why we have concluded that the credit-invoice method is the preferred choice.

VAT—IN GENERAL

The VAT is a general tax on expenditures for goods and services and is designed to be borne ultimately by the consumers of goods and services within the country having the VAT. The collection of the tax is achieved through a system whereby each entrepreneur delivering goods or rendering services collects and pays tax periodically at fixed rates on the value of the goods or services attributable to him (i.e., the value added by the entrepreneur).

From an economic standpoint, a separately stated VAT on the sale of goods and services appears to be the least damaging way of raising revenue. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S. or abroad.

A VAT would have less of an impact on business decisions than does the current income tax because it does not favor either capital or labor intensive industries. In other words, wages, rent, interest and profits—the return to the factors of production, labor, land, capital and entrepreneurship—each bear the same direct tax burden. The credit approach helps assure this result by providing businesses almost immediate credit for any VAT paid on capital outlays.

Additionally, a VAT levied at the same rate on all consumption should not cause a significant distortion in consumption choices since the relative cost of goods and services would be the same after imposition of the VAT as before. There would, of course, be some reduction in overall consumption due to a loss of real income caused by the imposition of a new tax.

A VAT is neutral with respect to goods produced domestically and abroad. Not only are U.S. manufactured goods not burdened with a VAT when they are exported, but also imports must bear the same tax as comparable domestic goods for sale here. A U.S. exporter would claim credit (or refund) for all VAT paid suppliers on exported products, but collect and remit none on the export sale. Conversely, importers would become liable for VAT on the value of all goods at the time of importation, subject to credit against VAT collected on the resale of such goods.

This border adjustment feature of the VAT, permitted under GATT[1] rules, means that the tax does not handicap U.S. manufacturers, nor does it act to distort consumers' decisions whether to buy domestic or imported goods.

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[1] The General Agreement on Tariffs and Trade (GATT) establishes the chief legal and policy framework for the administration of border taxes among the leading industrial countries. In practice, under the GATT rules border adjustments have been permitted for indirect taxes (value-added taxes; excise taxes; single or multi-stage sales taxes), and denied with respect to national direct taxes (personal and corporate income taxes; capital gains taxes; property taxes; and employer/employee FICA taxes)

The VAT has the advantage of not favoring consumption over savings in contrast to today's income tax. Many economists are of the opinion that the United States' overall savings rate is too low to provide adequate capital for investment. They have also stated that a VAT could be a good counterbalance to the income tax and a useful tool to help increase the nation's savings rate, especially in contrast to a heavier reliance on the income tax for deficit reduction.

In contrast to certain other excise taxes which are often proposed for deficit reduction, a broadly based VAT would not unduly burden the products of any one sector of the economy in the search for a solution to what is a national problem. In this regard, the VAT is superior to increases in existing excise taxes such as the motor fuel tax and the "sin" taxes. Similarly, any regional distortions would tend to be minimized since no product or sector of the country is the focal point of deficit reduction efforts. It also follows from the foregoing that a uniform tax applied to goods and services would induce fewer distortions than other taxes within particular industries. Additionally, the credit-invoice form of VAT can easily be made visible to the consumer by separately stating it on each invoice, just as state sales taxes are.

A further comparison between the VAT and income tax changes is warranted since these are the two choices with the most revenue potential and furthest reaching implications. There is little doubt that a VAT would have some near-term adverse economic effects. However, the basic distortions of an income tax should be recalled so that the reasons for favoring a VAT can be fully appreciated: income taxes distort the choices of methods of finance (debt-equity ratios and dividend payout rates), choices of form of doing business (corporate v. non-corporate), choices of production technology (capital- v. labor-intensive) and consumption decisions (corporate v. non-corporate products, tax-deductible expenditures v. others). In contrast to the income tax, the VAT is more neutral with respect to these choices.

Over time, the additional savings (which can be invested in new plant and equipment) that are expected if a VAT is enacted instead of income taxes being increased, plus the lack of adverse impact on capital investment, will outweigh any short term advantages the income tax might have, particularly in view of the distortions an income tax promotes.

CREDIT-INVOICE AND SUBTRACTION METHODS

Under the credit-invoice method VAT, the tax liability of a firm is equal to the tax imposed on its sales minus the tax it has paid on purchases for business use. Under the subtraction method VAT, tax liability is determined by applying the tax rate directly to the firm's value added, or the difference between its sales and its purchases.

While economists argue that theoretically the credit-invoice and subtraction method are identical, it is important to keep in mind that the credit invoice VAT is a tax on a product while the subtraction VAT operates like (indeed many commentators say *is*) a tax on a business. From that underlying distinction flow a number of practical differences which API concludes favor the credit-invoice method.

1. *Effect of multiple rates or exemptions.* Most commentators agree that while a single rate, no exemption VAT is preferable, the overwhelming weight of political experience shows that the United States would not adopt an across-the-board VAT with no exemptions.

The experience of the 45 countries who now have VATs is that *not one* of them has a single-rate, no-exemption VAT. A majority—30 of the 45—have both exemptions and multiple rates. Thirteen of the remaining fourteen have one rate, but multiple exemptions. The fourteenth—New Zealand—comes closest to a clean tax—one rate and very limited exemptions. Significantly, all 44 of these countries use the credit method. (Japan has recently adopted a VAT, which went into effect April 1. It has multiple rates with many exemptions, and appears to be a hybrid of the credit and subtraction methods.) The Canadian government has also recently proposed a credit-invoice VAT.

U.S. politicians are subject to exactly the same forces as the politicians of these other countries that already have VATS, and it is highly unlikely that Congress would put in place a tax that did not favor some goods, or businesses, or consumers—if for no other reason than to reduce regressivity. Regressivity is a problem with a VAT as it is with any consumption tax. API believes it would be preferable to address the regressivity issue through mechanisms outside the VAT itself—income tax credits or transfer payments, e.g.—but we recognize that it is highly unlikely that Congress would enact a single-rate no exemption tax.

It is virtually impossible for the subtraction method to properly handle multiple rates or exemptions. The credit invoice method, on the other hand, readily accommodates these features. Under the credit invoice method, if no tax is collected at a particular stage in the chain, the next firm in the chain has no purchase tax to credit against its sales tax liability, and the full amount of tax will be collected at that stage. The result is that a given product always bears the full amount of tax at the final retail stage.

Under the subtraction VAT, on the other hand, a firm's tax liability is not reduced or increased depending on whether it does or does not make taxable purchases from another firm. It simply adds up all its purchases, subtracts them from its total sales and applies the appropriate VAT rate to the difference. If tax is not imposed at some stage in the chain, it is not recaptured at any following stage. Under the subtraction method, therefore, the total tax included in the final retail sales price of a product is reduced by any exemption or preferential rates applied at pre-retail stages. Because the nexus of taxation in the subtraction method is the firm rather than the transaction, under the subtraction method firms and industries might be more likely to seek special treatment than under the credit method.

2. *Border tax adjustments.* Since the tax on a final product depends exclusively on the tax rate applied at the final sale, the credit method, in contrast to the subtraction method, permits the correct amount of tax to be rebated on exports and imposed on imports for border tax adjustment purposes. This is the primary reason the European Community adopted the credit-method VAT.

With the credit method, the entire tax is relieved on exports simply by applying a rate of zero (known as "zero-rating") to export sales and allowing the exporter a full refund (or credit) for tax paid on purchases for business use.

Under the subtraction method, on the other hand, it does not suffice simply to apply a zero rate to export sales. That frees the exporter's value added from tax but does not eliminate the tax paid on the exporter's purchases. Calculation of the purchase tax is not difficult if all purchases have been taxed at the same rate. But, consider a fairly complex example where a product moves through 10 stages of production and distribution, each taxed at a different rate. When the product is ultimately ready for export, there is no way, absent some elaborate tracing procedure, to determine how much actual tax has been imposed on that product. In this case the refund is not simply equal to the pre-tax value of purchases multiplied by a single tax rate.

With respect to imports, unless it is a final sale, it is not even necessary to impose tax under the credit method. The tax is merely collected on the first domestic sale through the absence of a credit. Under the subtraction method, unless domestic sales are all taxed at a uniform rate, it would not be possible to know the equivalent tax to impose on imports.

3. *GATT implications.* Another international trade issue also favors the credit-invoice method, even in the absence of multiple rates and exemptions. And that is the issue of whether our trading partners would permit border adjustments for a subtraction VAT.

Under the General Agreement on Tariffs and Trade (GATT), a tax on a product—such as a VAT or a sales tax—may be imposed on imports and rebated on exports. This is known as destination principle treatment—goods are, in effect, taxed where they are consumed, rather than where they are produced. In contrast, a direct tax on a firm, such as the corporate income tax, may not be rebated on exports nor imposed on imports.

Because the subtraction method VAT operates like a tax on a business, it is unclear whether other countries under GATT would permit the United States to rebate the tax on exports and impose it on imports. Most commentators agree they would not.

4. *Simplicity of administration and compliance.* Proponents of the subtraction method argue that it is much simpler than the credit-invoice method both for taxpayers and tax administrators—that it would only require one additional line on the federal income tax return while the credit-invoice method would require mounds of additional paperwork. This is simply not the case.

For any tax, taxpayers must maintain records which support the information filed on their tax returns. Under both the subtraction and credit-invoice methods, purchase and sales invoices and other appropriate documentation must be maintained. If the VAT is single-rated with no exemptions, then arguably the two methods should be equally easy to administer and comply with. If, on the other hand, any variations are introduced—multiple rates or exemptions—then it is the subtraction method, not the credit method, which creates the complexities.

5. *Visibility of the VAT.* Conservatives often argue that a VAT would become a "money machine" for big government—that because it is a "hidden tax" Congress could easily ratchet up the rates to fund vast new programs.

That might be more likely with a subtraction style VAT which operates like a tax on business and is buried in the price of goods and services. It is certainly not the case with a credit-invoice style VAT, where the tax is separately stated at every stage including the final retail sale. How many consumers, for example, know that included in the cost of goods they purchase is some portion of a 34 percent corporate income tax? They are far more likely to know the sales tax rate in their state because they pay it directly.

Moreover, the history of the credit-invoice VAT demonstrates that the tax itself does not cause big government. A study published by the *National Tax Journal*[2] compared the spending habits of 24 countries: 12 European nations with VATs and 12 industrial nations without VATs. There was no essential difference in the behavior of the size of government in the two groups over a 15-year period—either before or after VATs were introduced. The conclusion drawn from this data is that a VAT is a way to finance government spending, but not necessarily a cause of it.

SUMMARY

In summary, API's position is that the deficit is a problem that should be dealt with by controlling the growth of government spending. However, if Congress decides that a major revenue increase is necessary, we believe that a consumption value added tax would be preferable to other taxes. Of the methods of imposing a VAT, API supports the credit-invoice method.

Statement of the Associated Equipment Distributors

(Submitted by Anthony J. Obadal, Washington Counsel)

Members of the Associated Equipment Distributors (AED) supply, rent and service all types of light and heavy equipment used in the construction, mining, utility and forestry industries. Distributors provide professional assistance in the selection of appropriate equipment. We train mechanics to service and operators to use this machinery. We maintain large inventories for repair and replacement needs. We provide financial services for large items and open account financing for rental parts and service work. Distributorships are highly leveraged, relying extensively on credit.

About seventy percent (70%) of the top companies in the industry hold membership in AED. In the United States the full service equipment industry is composed of some 1,100 firms operating out of nearly 3,000 locations. Total industry volume for 1988 was approximately $12.95 billion. Employment is estimated at more than 50,000 people.

The typical distributor is an independent entrepreneur. Frequently, distributorships are family enterprises which have been owned and managed by two or three generations of family members. Others are acquired by key employees who, in turn, pass their businesses along to their children or still other employees. Many of our businesses have established ESOPs which provide retirement income for our employees, including family members working in the enterprise.

This unique group of entrepreneurs now find that their continuance as independent, family-owned enterprises is seriously jeopardized by the estate tax provisions of the Internal Revenue Code—particularly the requirements of 2036(c).

BACKGROUND

Section 2036(c) of the Internal Revenue Code was enacted as part of the Omnibus Budget Reconciliation Act of 1987, and was amended by the Technical and Modification Reconciliation Act of 1988. It was adopted without any public hearings, no notice or opportunity to comment was given interested parties. The statute apparently was intended to eliminate perceived unfair transfer tax advantages when estate valuation freezes were utilized by family members to assist in the transfer of business enterprises.

In a freeze transaction the right to the appreciation of a business is transferred, by sale or gift while, the transferrer retains a beneficial interest in the enterprise through preferred stock, a loan or an employment agreement, which assures the transferor a share in the income of the business. Voting rights are sometimes retained by the transferor.

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[2] "Value-Added Taxes and the Size of Government: Some Evidence;" J. A. Stockfisch; *National Tax Journal*, Vol. XXXVIII, No. 4, December 1985, pg. 547.

Under a typical estate-freeze transaction *prior* to 2036(c), parents who owned a business could recapitalize their enterprise, convert their common stock into preferred and have the company issue new common stock to the children bearing the rights to *future* appreciation. If the common stock was not purchased by the children, a gift tax was paid on its value at the time of transfer. The preferred stock had a fixed value and was frozen at that value for tax purposes. An annual income through the preferred dividends was received by the parent on which income taxes were paid. This transfer technique reduced the estate taxes which might have had to be paid when the transferor died while having the added advantage of preserving continuity, keeping the older generation involved in the business, and providing the older principal with a regular income. The children benefited as the value of the common stock grew through their own efforts since the increase in the business' value (i.e., its appreciation) was not included in the parents' estate. The assets of the enterprise absolutely essential to a business' continuance and growth were preserved and passed from one generation to another. Thus, the sale of the business to pay taxes was not necessary.[1] Other freezes involved loans or the establishment of special trusts.

Section 2036(c) subjects freeze transactions to estate taxes whenever the transferor transfers a disproportionate share of the appreciation of an enterprise while retaining an interest in the business, i.e., preferred stock, notes, the retention of voting rights and even an agreement to perform services tied to business profits are included in the definition of a retained interest. Additionally, under 2036(c), the holdings of a spouse are considered part of the retained interest of the transferor.

Section 2036(c) does not apply where the transferor receives full and adequate consideration *from a third-party* for the transfer of the disproportionate interest. This exception, however, is not available for transfers to family members to whom special rules apply.

The statute contains several safe harbors which are of little, if any, assistance to many businesses. For example, the retention or receipt by the transferor of debt that meets certain criteria or qualifications will not be considered a retained interest that triggers the provisions of § 2036(c). Thus, such qualified debt cannot be subordinated to the claims of general creditors, save one. A provision which could wreak havoc on businesses relying extensively on credit. Additionally, qualified debts must be repaid within a fifteen (15) year period and provide for market rates of interest; these qualifications are unrelated to the amount of the debt or the income of the enterprise, and therefore are impractical in many instances. Moreover, the indebtedness cannot grant voting rights to the transferor to whom the debt is owed—a provision which prevents the transferor from having an effective voice in the management of the corporation even though it is by no means unusual for large creditors to demand such rights to protect their interests.[2]

EFFECTS OF SEC. 2036 (C) AND THE ESTATE TAX PROVISIONS

AED distributors rely on their businesses for their livelihood. Owners operate on small profit margins and put their savings back into the-business to assure continued growth and creditworthiness. Consequently, they generally lack the independent wealth necessary to pay estate taxes incurred under present law. Accountants, tax and financial planners have informed distributor after distributor that the provisions of §2036(c) may well require the sale of the business upon the death of the principal or spouse.

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[1] Currently, federal estate taxes have a $600,000 credit, a starting rate of approximately 35% and a top rate of approximately 55%.

[2] Harry L. Gutman, Professor of Law, University of Pennsylvania when appearing before the Senate Finance Committee on May It, 1989, asserted that, in his view, 2036(c) would not be triggered by the transfer of non-voting stock while voting stock was retained. This gratuitous legal opinion may be correct; but those attorneys and tax consultants—who can be held liable if their advice leads a client to financial disaster—are by no means as quick to draw this conclusion as is Mr. Gutman. For example, Ms. Shirley D. Peterson, of the law firm of Steptoe and Johnson, in her analysis dated December 2, 1988, entitled *Transfer Tax and the Family Enterprise,* points out that even "some member[s] of the tax writing staff [of the Congressional Committees] have suggested that the transfer of non-voting common shares by the owner of the voting common would be encompassed by 2036(c)" (p. 13). See, also, the warnings of Roger D. Aucutt of Miller and Chevalier in *The Impact of 2036(c),* October 3, 1988 (p. 19), where he states "that the word 'disproportionately' invites a comparison to the transferor's entire interest, including the right to vote . . .". Moreover, the Peterson and Aucutt opinions are certainly more consistent with the clear Congressional intent expressed with respect to the qualified debt safe harbor which excludes retention of voting rights. Mr. Gutman's position is, at best, arguable and cannot be relied upon when large sums of money are at stake. Hopefully, this issue will be clarified when the Internal Revenue Service releases its views this summer.

Bob Schwarzmann, President and major stockholder of A&R Tool and Equipment Rental and Sales of Falls Church, Virginia is typical of the estate tax situation in which dealers are now enmeshed. He borrowed One Thousand Dollars ($1000.00) in 1959 to begin his rental equipment business. His wife worked as a telephone operator to support his efforts and their three children. As his business grew, his wife joined the enterprise, as did two of their children and a son-in-law. His third child is handicapped and totally depends on the family's efforts for his support. The family works six days a week, ten hours a day. Some years ago his business purchased the land on which it operates. This business now has a gross of $3.5-4 million per year; its estimated resale value is $6 million; the real property has soared in value and is now worth more than the business itself.

Prior to the adoption of 2036(c) the Schwarzmanns' could have planned to keep this enterprise in the family. They could have divided it in a manner that took care of all the economic needs of the individual family members. The elder Schwarzmann's could have taken preferred stock and retained control until their children were ready and had the business maturity to assume management. The children who were participants in the business initially could have been given non-voting common shares and would have benefited as the appreciation of the enterprise grew. This stake in the enterprise would have helped keep their interest and would have encouraged them to make the personal sacrifices necessary for business growth. Their handicapped child—as a non-participant in the enterprise—could have been given non-voting stock that returned a lower share of income than the regular common. Their son-in-law could have been given non-voting stock that returned a share equal to the regular common held by the other participants in the business.

Now, Mr. Schwarzmann is confronted with the bad news of § 2036(c). All of the above described transfers trigger § 2036(c) requiring the inclusion of the value of the transferred stock at the time of their death in the parents' estate. He comments, "My family and I have worked all our lives to provide ourselves with an independent living. We put all our efforts and money into our business. We have no objection to paying our fair share of taxes but now I'm told that once my wife and I die, my children will have to sell *their* business to pay the tax debt. I live near Washington, but I do not understand these people working on Capitol Hill, nor, do they seem to understand us."

Roy Hunt, President and Owner of Hunt Tractor in Louisville, Kentucky is in a similar situation. Mr. Hunt's father, R.S. Hunt started an equipment distribution business in 1922 on a part-time basis handling one line of equipment. The chief source of income for this entrepreneur was the family farm which was worked by his two sons, Roy and Raymond. Mr. Hunt and his brother took over management of the equipment distribution arm of the family business as their father's health failed and the manufacturer demanded that they begin full scale operation. After working and building the business for five years, the sons bought the business upon the demise of their father at its fair market value. In 1975, Roy's son Scott joined his father as a salesman and together they purchased Raymond's share. Presently, Scott is Vice President and looking forward to carrying the family business into the future for his family, as well as protecting the interest of his sister, Judy. Mr. Hunt's accountants have advised him that the possibility of Scott having to sell the business to pay federal estate taxes is a significant threat under the present interpretation of § 2036(c). Noting that family firms create jobs and foster business development, Mr. Hunt observes, "Maybe that is what our Congress wants, but it is not what our economy needs."

SPECIAL FRANCHISE INDUSTRY PROBLEM

In equipment distribution—as in other franchise-related industries—a number of manufacturers and franchisers have traditionally exercised a controlling voice in selecting successor owners of outlets distributing their product or using their trademarks. It is their view that in order to protect the products' reputation and good name they must make certain that their products are distributed and serviced by qualified and trained business professionals who bear full responsibility for the success of the enterprise. Consequently, many manufacturers retain the right to approve or disapprove, as they see fit, those seeking to purchase equipment distribution establishments. They seek "hands-on" owners and often discourage sales to large corporations who will operate distributorships through hired managers. As a result, considerable time and care is taken to train prospective distributor successors.

Successors are generally family members or key employees who have spent years with the enterprise but who lack the independent wealth necessary to purchase distributorships. Estate freezes, long term loans not meeting the current criteria of 2036(c), and retention of voting control by the more experienced generation during ownership transition periods have all been used to work out successorships that are not only acceptable to manufacturers but also are economically feasible and otherwise beneficial to the enterprise involved. The use of such devices now will trigger 2036(c) and necessitate, in many instances, attempted sales to cash-rich parties—generally large corporations.

These circumstances raise this problem—to whom do distributors sell in order to raise the funds necessary to pay the estate taxes? If an experienced successor, with substantial funds meeting manufacturer approval, cannot be found the distributorship will have to be sold for asset value only. Value factors attributable to current income, good will and other items will be lost—not only to heirs, but also for tax valuation purposes. 2036(c) thus will not produce the federal revenue anticipated—and will, at the same time, destroy enterprises that have been productive and which are a substantial benefit to our society.

REPEAL SECTION 2036(C)

Examples like Messrs. Schwarzmann and Hunt abound among independently-owned distributorships and there is no reason to believe that their situations are unique. Every family business, every closely-held corporation, including farmers, trucking firms, warehousemen, automobile dealers, grocery operators, printing shops, computer companies, insurance agencies, public relations firms, contracting companies, engineering firms, high-tech companies, minority enterprises—the list is endless—all, are subject to destruction through the application of 2036(c) and the current estate tax provisions.

Tom Hansen, accountant and tax advisor with the firm of Hansen, Plahm and Company, provides services to equipment distributors in and around the Chicago area. Mr. Hansen warns, Section 2036(c) threatens to end family-owned enterprises in the equipment distribution and other industries. I am deeply disturbed by what is occurring, it is an insult to the integrity of small business operations which have made this nation successful. It is both ironic and tragic that as I see a family company grow I despair with the realization that this business ultimately may well have to be sold for estate tax purposes."

The Associated Equipment Distributors and its members strongly urge the Finance Committee to repeal § 2036(c). We join with Senator Daschle who urged this course when he introduced S. 849 on April 19, 1989 for himself, Senators Heflin, Boren and Symms. At that time he stated, in part:

> I am very concerned that, through § 2036(c), as currently written, many parents will work all their lives to build a family business only to be forced to sell it for tax reasons. That is just not right . . . the effect of § 2036(c) may ultimately be to create a strong disincentive for people to build family businesses. This would be a grave consequence at a time we should be encouraging entrepreneurial activity . . . finding a better way of targeting the abuse originally envisioned by Congress may take considerable time and study . . . in light of these difficulties I believe it unfair to allow the menace of § 2036(c) to remain.

AED respectfully urges Congress to encourage the continuation, not bid goodbye, to family enterprise. § 2036(c) should be repealed now. Time can then be taken to carefully draft an alternative. Initially, we suggest, that if an alternative is deemed necessary, it be directed to the valuation problem and take into account the income stream of the particular enterprise.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 individuals. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. AGC appreciates this opportunity to comment on the estate valuation freeze rules.

The construction industry is composed predominantly of small, family-owned firms competing in local geographic markets. Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualifies under the Small Business Administration's definition of a small business.

AGC supports S. 659; S. 838 and S. 849, the Senate's proposals to repeal Section 2036(c), the estate valuation freeze rules, as well as H.R. 60 and H. Res. 139, the House repeal proposals. Section 2036(c) was added to the Internal Revenue Code without any hearings and with little advance notice. It penalizes the family business, which is the sector of the American economy that generates the most innovation, as well as the most new jobs.

HISTORY

A parent or member of an older generation wishes to motivate the children or members of a younger generation to stay in the family business. The parent may also wish to ensure that when the parent dies, there would not be so much equity in the company that the next generation cannot raise enough money to buy it or to pay estate taxes on it. The parent may also wish to ensure a steady retirement income.

The parent would cause the company to recapitalize. A preferred stock class would be created for the parent. The parent would receive a steady income after building up the company and retain some interest in the company's continuation. A common stock class would be created for the next generation which would appreciate in value as the company appreciated. The next generation would reap the benefits of working to ensure the continuation and growth of the family business. The equity of the business could stay in the business. The value of the business in the parent's estate was frozen at the preferred stock level.

The Revenue Act of 1987 added Section 2036(c) to the Code. If a person holds a substantial interest in an enterprise and after December 17, 1987, in effect transfers property having a disproportionately large share of potential appreciation in the enterprise while retaining an interest in the income of, or rights in the enterprise, the retention of that interest is considered a retention of the enjoyment of the transferred property. The value of the transferred property comes back into the parent's estate. Section 2036(c) eliminated the traditional corporate and partnership estate freezing techniques. As originally enacted Section 2036(c) went far beyond those basic transactions. It also covered a variety of other business transactions. The 1988 Tax and Miscellaneous Revenue Act (TAMRA) amended Section 2036(c). The act added several safe harbors, but it also added a deemed gift rule. Congress also granted the IRS unusually broad authority to write regulations in this area and to expand the types of distributions to which it applies.

PROBLEMS WITH SECTION 2036(C)

AGC has identified several specific problems with Section 2036(c) as it now exists. The IRS has not yet issued regulations in this area. Taxpayers attempting to comply with the statute may find themselves facing further unexpected problems with the broad authority given the IRS and the unclear language of the statute.

"Potential Appreciation" Not Defined. The legislative language does not define "potential appreciation" or explain how to estimate it. Section 2036(c) does not establish the time to determine whether the substantial interest test is met or not met. The House language indicated the substantial interest test would be met if the parent held a substantial interest either before or after the effective transfer. The conference agreement did not adopt that provision.

"Enterprise." Section 2036(c) applies to the transfer and retention of interests in an "enterprise." Enterprise has not been defined, but the conference report states that it includes a business "or other property which may produce income or gain." This creates a great deal of uncertainty, as this language could cover life insurance policies or a personal residence.

Safe Harbors. TAMRA added several safe harbors, which do provide some guidance when structuring business and family transactions. Unfortunately, by setting rules that certain transactions must satisfy in order to fall within the safe harbors, Congress has created a risk that transactions not strictly falling within one of the limited statutory safe harbors may be subject to Section 2036(c).

Deemed Gift. TAMRA also added a type of gift tax provision. If the original transferee (the younger generation) transfers that property to a person other than the family of the parent (original transferor), then the parent is treated as making a gift to the original transferee. If the parent transfers the retained interest, the parent is also treated as having made a gift.

Sale to Family Member. Section 2036(c) may also apply to the sale of a closely held business or investment assets to a family member at fair market value. The exception for arm's-length sales does not apply to sales to a family member. If the parent retains an interest in the income of the business (or asset), the interest sold is includable in the parent's estate.

CONCLUSIONS AND RECOMMENDATIONS

AGC believes incentives for entrepreneurship and capital growth are vital for a healthy, growing and competitive economy. To foster competitive and innovative businesses, which in turn provide economic growth and jobs, tax policy must provide incentives for hard work and entrepreneurship. Section 2036(c) penalizes family businesses by penalizing efforts to encourage children to join the business. It encourages sales to people outside the family.

For small and emerging businesses to thrive, AGC believes the founders need to leave capital in the business. In the construction industry, insurance and bonding capability are directly impacted by the business's capital structure. Without techniques such as estate freezes, the founder may die and leave so much valuable equity in the business that the next generation cannot raise enough money to buy it or pay estate taxes on it.

The next generation is so hampered by Section 2036(c) that it makes more economic sense for them to work elsewhere than to stay in the business. If the children stay and work to make the business prosper, it is extraordinarily difficult for them to get equity in the business. The next generation is now deciding with ever-increasing frequency that it is not worthwhile to work a minimum of 60 or 70 hours a week in a business in which their future participation is made virtually impossible as a consequence of Section 2036(c) They are deciding to work elsewhere. When the founder wants to pass the business on, he or she has no one to pass it to.

People need incentives to take risks. One of the incentives in forming a family business is the opportunity to pass something on to the next generation. Without appropriate incentives, the risks are not worthwhile.

The interaction of the estate valuation freeze rules with the other recent tax code changes are hurting small businesses. For example, the 1986 tax reform act repealed the General Utilities doctrine. Previously, a single tax was paid at the shareholder level on liquidating sales and distributions of a business. The proceeds were not taxed at the corporate level. Now, if the owner retires and liquidates the business, the double taxation reduces the amount the owner will realize on sale of the business.

The proceeds from the sale of the company would be further reduced by the repeal of preferential tax treatment for long-term capital assets. The 1988 tax act further reduced the ability of the owner to sell the corporation. Sales of property are restricted in their use of the installment method of reporting income.

When these provisions are taken together with the estate freeze rules, the impact on family businesses is very severe. Owners of construction companies who have devoted a lifetime to building equity in a business and who want to transfer it to the next generation, employees or even sell it to strangers, cannot do so at the close of their career without being subjected to confiscatory tax rates. AGC believes the most innovative and productive sector of the economy deserves better. AGC recommends Section 2036(c) be repealed.

STATEMENT OF ASSOCIATION FOR ADVANCED LIFE UNDERWRITING AND THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

On behalf of the Association for Advanced Life Underwriting (AALU) and the National Association of Life Underwriters (NALU) the following comments are submitted regarding S. 659, S. 838 and S. 849, bills designed to repeal Section 2036(c) of the Internal Revenue Code of 1986, relating to estate valuation freezes. This statement is made in connection with Senate Finance Committee hearings held on May 17, 1989.

AALU, which is a conference of NALU, is a nationwide organization of more than 1,500 life insurance agents and others engaged in the use of life insurance and related products in the fields of business continuation planning, estate planning, retirement plans and employee benefits. Much of the work performed by its members relates to small businesses and their special problems.

NALU, which has a membership of 1,022 state and local associations with combined individual membership of over 140,000 life insurance agents, general agents and managers, joins AALU in the submission of these comments.

AALU and NALU associate themselves with the ever-increasing numbers of tax practitioners, bar associations, trade associations, accountants, and other tax professionals who seek the repeal of Section 2036(c). We urge Congress to restore stability to the transfer tax area.

Life insurance is designed to allow our citizens to cope with financial and liquidity needs which may be met only after sound judgments and projections are made concerning future transfer tax liabilities. With the introduction of Section 2036(c) to the tax code, sound planning projections have, in many situations, become impossible. Because the statute is so vague and potentially far-reaching, it introduces uncertainties, with regard to future transfer tax liabilities, that cannot be overcome, even by the most careful and precise planning methods.

Added to the Internal Revenue Code by the Revenue Act of 1987 and substantially modified in the Technical and Miscellaneous Revenue Act of 1988, Section 2036(c) is aimed primarily at curbing perceived abuses in the transfer tax system, such as the use of estate freezes whereby a transferor transfers future appreciation in the value of a business while retaining a preferred or frozen interest. Congress was concerned that business interests transferred within the family unit were being undervalued, and thus under-taxed, for transfer tax purposes.

While Congress may have intended to curb abusive estate freeze arrangements, the statute goes well beyond that standard and effectively applies to many intrafamily transactions which are not abusive and which occur in the normal course of the operation of a closely-held business. Section 2036(c) creates a serious tax disincentive to the continuation of family businesses. The statute discourages gifts and sales of family-owned businesses among family members and encourages sales to non-family members. At a time when the family-owned business is in economic jeopardy from non-tax sources, it is unwise for Congress to apply unnecessary additional tax pressure.

Moreover, Section 2036(c) imposes an unpredictable and often capricious tax liability not only on the original transferor, but also on any number of family members along the line of property devolution. The amount of the potential tax cannot be predicted because it is based on two unknowns: the future appreciation of the property and the date on which the tax may be triggered. That date may be the date of death of the original transferor, it may be the date of other transfers by the original transferor, or it may be the date of transfers by the transferee. Moreover, the transfer tax liability may be doubled if the transfer is to a grandchild and the generation-skipping transfer tax is triggered.

Section 2036(c) is also overly broad and vague. The statute is to apply whenever a person, who "holds a substantial interest in an enterprise," . . . "in effect transfers" . . . "property having a disproportionately large share of the potential appreciation in such person's interest while retaining an interest in the income of, or rights in, the enterprise." Because the Conference Report's definitions of "enterprise" and "transfer" are so broad, the scope of the statute is unclear and appears to reach many ordinary business transactions and family investment arrangements.

The statute's basic vagueness has caused the Treasury to indicate that it will issue clarifying regulations. In anticipation of such issuance, estate and insurance planning has been substantially impaired and, in many situations, has come to a virtual halt. However, the now long-awaited regulations are unlikely to cure this malady. For instance, there are many questions concerning the meaning of the statutory term "enterprise." In order for Section 2036(c) to apply to a transaction, there must be a transfer of an interest in an "enterprise." The term "enterprise" is not defined in the statute, although the 1987 Conference Committee Report states expansively (too expansively) that, "an enterprise includes a business or other property which may produce income or gain."

It is generally expected in Washington that the regulations will describe the term "enterprise" as a business undertaking, as distinguished from a personal use asset. A Treasury spokesman has stated that examples of personal use assets may include such items as personal residences and art works, "except perhaps for a Van Gogh." Will the Revenue Service take on the job of art critic and make distinctions between works of art that are personal use assets and ones that are a business undertaking? If the personal use/business undertaking distinction is adopted, it would mark the first time that the application of the transfer tax would be based upon the *type* of property which is the subject of the transfer.

Even if the personal use/business undertaking distinction is not adopted, Section 2036(c) will constitute a dramatic departure from general concepts of transfer taxation. This provision marks the first time that a transferor of property may be taxed long after he has severed all connection with that property. The transfer tax laws now in this regard will diverge from basic property law concepts. In addition, this provision represents the first time that sales for full and adequate consideration may result in transfer taxation.

Another example of statutory overreaching is the rule that "except as provided by regulation" an individual and his or her spouse are to be treated as one person. Giving the Treasury Department the authority to determine when an individual will be taxed on property in which his or her spouse has an interest is not only an instance of departure from basic property and transfer tax concepts, but injects a substantial degree of uncertainty in the law.

While the pertinent legislative history is devoid of any indication that Section 2036(c) was meant to apply to life insurance arrangements, expansive statements by Treasury personnel have created suggestions that life insurance may be susceptible to the reach of this new section. We understand that the anticipated Treasury Regulations are likely to put these suggestions to rest. However, the mere fact that Section 2036(c) can be manipulated to create such doubts is a strong confirmation of the need for its repeal.

Section 2036(c) should be repealed because it is unworkable, unfair, and economically disruptive, particularly to closely-held businesses. Congress should then devote the requisite time to produce a workable and fair statute to curb the perceived abuses in the present system. For example, a statute requiring careful scrutiny of valuation abuses at the gift tax level would be a far better approach.

The flaws in Section 2036(c) are not susceptible to adequate cure by the administrative process. The stability in the transfer tax system can be restored only by the repeal of the section.

Thank you.

STATEMENT OF THE COLLEGE SAVINGS BANK

(SUBMITTED BY PETER A. ROBERTS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER)

"THE COLLEGE SAVINGS CRISIS: PREEMPTIVE FEDERAL SAVINGS PRODUCTS ARE NOT THE RIGHT SOLUTION"

My comments are directed to U.S. Senate Bill 353, which would expand the category of individuals eligible to claim the income tax exclusion for Series EE Bonds used to pay for higher education expenses. The Bill would further the dominance of the Series EE Bond in the saving-for-college marketplace.

The Wrong Solution: A Preemptive Federal Savings Product

One solution to increasing the rate at which families save for college is to provide tax incentives. However, the tax incentives have to be carefully designed so as to permit college savers sufficient investment flexibility and encourage the participation of the private sector.

Congress recently took an important first step by enacting legislation that provides an incentive for college savings. The Technical and Miscellaneous Revenue Act of 1988 includes a provision that accords tax-exempt status to the interest earned on Series EE bonds if, at redemption, the proceeds are used to pay for college education costs. The provision applies to bonds purchased after January I, 1990, if the parents' income is below specified levels at the time of redemption.

In the short-run, this might increase college-targeted savings and, we all hope, overall savings. However, the provision, which was added on the Senate floor and which was never considered in mark-up by this full Committee, has several significant flaws with long-term consequences.

The new saving-for-college tax incentive converts the Series EE Savings Bond into a tax-exempt bond with a yield matching the taxable yields on other U.S. Treasury obligations (see Figure (1).

The effect of tax exemption on the new Series EE Bond is very different than the effect of tax exemption on a municipal bond. whereas the market adjusts the yield on municipal bonds to be lower than the yield on taxable bonds, the yield on the non- negotiable Series EE Bond is pegged to the yield on taxable Treasury bonds and therefore cannot seek equilibrium to the yields on other tax-exempt instruments. On a risk-adjusted basis, the after-tax rate of return on the Series EE Savings Bond preempts all other investments in the marketplace (see Figure (2).

This form of tax incentive will divert the portion of a family's total savings earmarked for college away from other forms of saving and into the Series EE Bonds. The disintermediation and market-damaging effects caused by a preemptive federal savings product will have a decidedly negative impact on competition and innovation (not to mention the adverse marginal impact on the savings and loan crisis). It will discourage the institutions that now seek to help college savers and reduce the range and variety of targeted college saving vehicles.

Let me give you a personal example. In 1987, the College Savings Bank introduced an innovative certificate of deposit that bears interest tied to the rate of college inflation and guarantees the future cost of college It allows parents to invest in their child's college education today for just a fraction of tomorrow's cost. In addition the Bank developed, with the approval of the FDIC, safe and sound banking practices which insure against this future liability. We thought these developments were major steps forward in encouraging savings for education.

Apparently so do the states that the Bank has advised and the growing number of colleges and universities that participate in our program. Michigan, Florida, and Wyoming have enacted college cost prepayment programs. I wonder whether any of these innovative and important savings programs would have been developed if a preemptive government college savings instrument had been available three years ago In fact, the State of Minnesota recently withdrew its saving-for-college initiative citing the preemptive nature of the new Series EE Bond legislation.

Furthermore, the Series EE Bond will distort investor choices. Given that the tax incentive is restricted to just one savings product, it will alter a family's choice of investments but will not necessarily increase the family's total volume of savings.

One test of every initiative offered in the name of progress is whether it is in harmony with sound economic principles. While the goals of the Series EE Savings Bond legislation and its expansion through 5.353 are admirable—and its authors should be given credit for developing a low-cost incentive—it fails this important test.

The Right Solution: A Level Playing Field

The best way to maximize the effectiveness of the tax benefits offered to college savers would not be to further the dominance of the Series EE Bonds over other investments but to extend the tax incentives granted to the Series EE Savings Bond to all financial instruments placed in a qualified College Savings Account. Contributions to a CSA would not be currently deductible but earnings in a CSA would be tax exempt if the CSA were used for qualified college educational expenses. The expanded program could be structured in such a way as to make sure that it does not cost any more than the Treasury estimated that the Series EE Bond college savings incentive would cost. Notwithstanding, revenue neutrality should not constrain the development of an economically efficient college savings incentive for the middle class.

The CSA would help level the playing field for all market participants and avoid the market-damaging effects caused by a preemptive federal savings product. The private sector has a comparative ability to cultivate thrift among this nation's families. It can provide college savers with a wide range of investment choices, reach a broader spectrum of eligible families, and create a competitive and innovative marketplace that is necessary to maximize the savings rate in this great country.

I urge this Committee to act quickly to effectuate legislation to expand the college savings incentive to the private sector by January 1, 1990 (Series EE Bond effective date). Delay will not only be disruptive to the saving-for-college marketplace but could also have serious and adverse long-term effects.

Conclusion

I strongly believe that there is a need to increase savings in this country. As a general rule, however, individuals have difficulty seeing the benefits—particularly the long-term benefits to the economy—of increased savings. College savings is one area where individuals can see the benefits of saving and an area where there is a shortage of savings. It is an area where saving incentives are most needed and can be most effective. To be truly effective, however, incentives must not crowd out the private sector. Therefore, the Committee should focus on extending the tax incentives granted the Series EE Bond to all savings placed in a qualified account rather than furthering the dominance of the Series EE Bonds.

I thank the Chairman and the Committee for the opportunity to express my views.

Appendix—College Savings Accounts

PARTIAL SUMMARY OF TERMS

Eligible Investments

Investments generally eligible for IRAs, Series EE Savings Bonds, college savings programs sponsored by states, etc.

Deductibility of Contributions

Contributions to CSAs will not be tax deductible.

Taxation of Earnings of CSAs

Earnings (interest and dividends) will not be taxed currently.

Exclusion from Income

Earnings that are part of qualified withdrawals will be excluded from income to the extent of qualified higher education expenses paid by the taxpayer.

General Limit on Annual Contributions

$10,000 per taxable year by parents. Income test similar to Series EE Bond legislation except applied at time of contribution instead of time of withdrawal. Contribution limit would be phased down for higher income families (possibly using the same phasedown ranges as the Series EE bond college savings program). The contribution limit and phasedown range would be indexed for inflation.

Holding Periods

Amounts held in CSAs (other than Series EE bonds) would have to be held five years to be eligible for favorable tax treatment.

Penalties; Nonqualified Withdrawals

In the case of a nonqualified withdrawal, e.g., a withdrawal that is not used to pay "qualified higher education expenses," or a disqualification of a CSA because the taxpayer ceased to have any children below college graduation age, the taxpayer generally would be required to include in income for the year of withdrawal the earnings that are part of the nonqualified withdrawal (and which would have been included in income in a prior year but for the CSA) and pay a penalty.

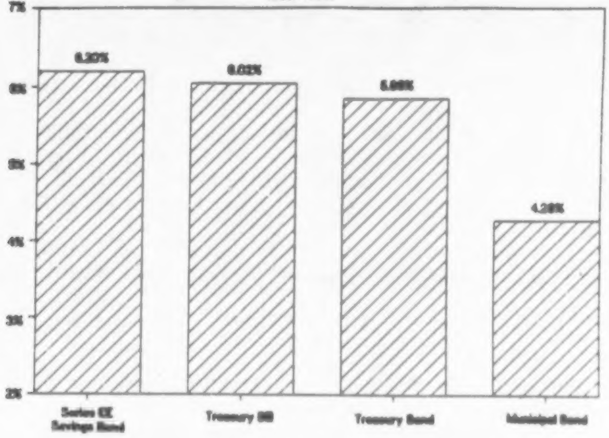
Effective Date

January 1, 1990. This would expand the Series EE Bond college savings program scheduled to become effective on that date.

Figure 1

Average Annual Pre-Tax Rates of Return on Selected U.S. Treasury and Municipal Securities

1958 - 1988



(a) Average annual rate of return on the U.S. Series EE Savings Bond was calculated retrospectively, as though the Series EE Bond had been in existence since 1958, based on 85% of the average annual yield of the 5-year constant maturity U.S. Treasury note, for the period since 1974, and 85% of the average annual yield of 3- to 5-year issues, for the period prior to 1974, in both cases as reported in various issues of the "Federal Reserve Bulletin". The floor rate and the early redemption penalties were not included in the calculation of the average annual rate of return.

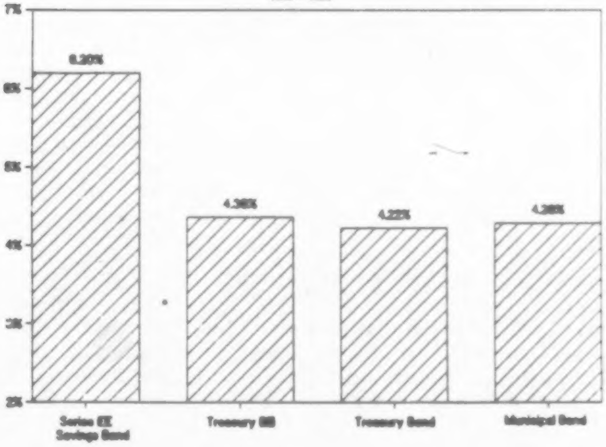
(b) Average annual rates of return on U.S. Treasury bonds and U.S. Treasury bills were calculated from total annual returns for the period 1958-1988 reported in "Stocks, Bonds, Bills and Inflation, 1989 Yearbook", Ibbotson Associates, Inc., Chicago, 1989.

(c) Average annual rate of return on municipal bonds was calculated in the same manner as Ibbotson Associates computed annual Treasury returns based on monthly yield data for 10-year municipal bonds reported in "Analytical Record of Yields and Yield Spreads", Salomon Brothers Inc., New York, June 1988 and monthly updates through January 1989.

Figure 2

Average Annual After-Tax Rates of Return on Selected U.S. Treasury and Municipal Securities

1958 - 1988



(a) Assumes a 28% marginal income tax rate

(b) The Series EE Savings Bond also provides a tax-deferred rate of return if the proceeds are applied to uses other than college savings. A 6.20% pre-tax rate yields a 4.77% tax-deferred rate if the bonds are held for 10 years.

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STATEMENT OF THE NATIONAL ASPHALT PAVEMENT ASSOCIATION

(SUBMITTED BY JOHN GRAY, PRESIDENT)

Mr. Chairman and Members of the Committee: I am concerned for the ability of this nation to provide the same opportunities to my sons and to their children as were provided to me. I remain equally concerned about this nation being able to defend itself and to represent the free enterprise system and capitalist ideals. I believe, however, that the greatest threat to our system is coming from our internal prodigality, and our apparent inability to deal with the real threat to our system, which is our rapidly expanding national debt, coupled with our significantly negative balance of trade payments.

We hear much conversation about the reduction of the deficit. We hear little conversation about expunging the national debt. It is plain and simple that if we did not have a national debt, there would be little or no deficit (Table I). I offer these comments, therefore, out of a deep concern, not only for America, but most importantly for the heritage which we will be leaving for future generations of Americans, focusing particularly on the problem of our growing national debt, but also to look at an alternate course which could set America on a road to financial stability.

THE NATIONAL DEBT RETIREMENT TRUST FUND

The Problem

In recent years, the budget deficits, and more particularly the increasing national debt of the federal government, have had a significant impact on the economic health and quality of life of the American people. As deficit spending continues, it adds to our national debt: as the debt grows, it adds to our budget costs and concomitantly to our budget deficits. (See Table I)

Until now, most of the public discussion on our economic problems has related to attacking the deficits, on the assumption that a reduction of the deficit rate would help stabilize the finance and investment markets. Although this is probably true, the equilibrium which the financial markets would receive would only be temporary and would not solve the real problem—the national debt.

As the publicly held national debt grows larger to finance the continuing budget deficits, the interest paid on that debt grows incrementally, creating even larger deficits and adding to that debt. Each rise in the interest rates, caused by heavy government borrowing, increases the burden as the Treasury Department must continue borrowing to pay the higher interest rates. For most years since 1940, the interest on the debt has been significantly larger than the budget deficits. (See Table I) If there were no national debt, the national budget would have been balanced and, in many years, there would have been a surplus.

An Alternative Approach

Any new approach which is offered should include both spending restraints and revenue enhancements in attempting to correct the deficiencies which exist in our current economic environment. It should: (1) limit federal expenditures to income; (2) limit the rate of growth of government spending; and (3) establish a system that will both reduce the deficits and begin reducing the principal of our national debt.

The approach I would offer would include: (1) a constitutional amendment for a balanced budget, coupled with a moratorium on budget increases for three years, and then limiting the rate at which government spending would be allowed to grow; and (2) establishing a *national debt retirement fund* financed with a *dedicated* national sales tax.

Constitutional Amendment for a Balanced Budget

From time-to-time, there has been considerable discussion regarding a balanced budget amendment. A balanced budget amendment, coupled with a moratorium on budget increases for a period of three years and a limited rate of growth of the budget after this initial period, would begin to lessen the federal government's dominance in the domestic finance markets and release increased funds for productive investment in the private sector.

National Debt Retirement Trust Fund

The national debt is projected to expand beyond $2.85 trillion by the end of this year (1989). The total interest that the government is paying on our national debt continues to increase, becoming a larger and larger share of the federal budget. In addition, a significant amount of our national debt is held by foreign investors. In fact, we have become dependent upon this source of funds. It is obvious, therefore, that we have a debt crisis and must move to begin to reduce the national debt and ultimately eliminate it.

I would suggest the establishment of a national debt retirement trust fund; funded with a 10% national sales tax (or a 10% value-added tax) that would go into the national debt retirement trust fund and be *solely dedicated* for the purpose of reducing, and ultimately expunging, the national debt and would automatically lapse when that debt had been retired.

Current information shows that a 10% national sales tax would generate approximately $300 billion per year in revenue. Assuming a balanced budget and modest increases in annual revenues generated by this 10% sales tax, it would take approximately 9–10 years to retire the entire national debt. Each year, as portions of the national debt are paid off, the debt service on the debt will be reduced accordingly. The reduced debt service payments will therefore directly result in reduced annual deficits. As the national debt and deficits are reduced, any surplus from general tax-generated monies could be directed into other financially troubled federal programs or could be used to accelerate the reduction of the national debt.

Summary

If the program suggested above were to be adopted, much of the current public concern over the nation's financial status would be resolved. With the national debt paid off, and a mandatory requirement for balanced federal budgets to preclude future deficits, the federal government would be largely removed as a competitor to private investors in the nation's financial markets.

Interest rates would be reduced, making housing and other private capital investments more affordable for consumers. Businesses could better afford to invest in capital improvements and modernization of existing facilities. Individuals would have increased incentives for personal savings and would aid in the expansion of capital funding available for the expansion and modernization of the national industrial base.

I am fully conscious of the political and economic downsides of a 10% national sales tax. However, I believe that Americans in general would commit themselves to the acceptance of such a tax if it could ensure future Americans a better opportunity to enjoy the fruits of their labor and not to be burdened by an ever-expanding debt incurred by previous generations.

To enact such a program will require considerable fortitude, but leadership displayed by such an action would demonstrate to the world our seriousness in this effort and could have the effect of stabilizing less affluent nations and making them think about living within their own means.

I believe that the majority of Americans would rally to this cause and would greatly respect a leadership which has a commitment to protecting America's future, as well as being able to glory in its past.

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TABLE I

Economic Status of the Federal Government

(All figures in billions of dollars.)

Year	Receipts	Outlays	Surplus/ Deficit	Outstanding Gross Debt	Interest Paid	Interest as % of Fed. Budget	Foreign Held Federal Debt	
								% of U.S. Gross Debt
1940	6.4	9.5	(3.1)	50.7	1.0	10.5		
1950	39.4	42.6	(3.1)	256.9	5.7	13.4		
1960	92.5	92.2	.3	290.9	9.2	10.0		
1970	192.8	195.6	(2.8)	382.6	19.3	9.9	14.0	3.7
1971	187.1	210.2	(23.0)	409.5	21.0	10.0	31.8	7.8
1972	207.3	230.7	(23.4)	437.3	21.8	9.4	49.2	11.3
1973	230.8	245.7	(14.9)	468.4	24.2	9.8	59.4	12.7
1974	263.2	269.4	(6.1)	486.2	29.3	10.9	56.8	11.7
1975	279.1	332.3	(53.2)	544.1	32.7	9.8	66.0	12.1
1976	298.1	371.8	(73.7)	631.9	37.1	10.0	69.8	11.0
1977	355.6	409.2	(53.6)	709.1	41.9	10.2	95.5	13.5
1978	399.6	458.7	(59.2)	780.4	48.7	10.6	121.0	15.5
1979	463.3	503.5	(40.2)	833.8	59.8	11.9	120.3	14.4
1980	517.1	590.9	(73.8)	914.3	74.9	12.7	121.7	13.3
1981	599.3	678.2	(78.9)	1,003.9	95.6	14.1	130.7	13.0
1982	617.8	745.7	(127.9)	1,147.0	117.4	15.7	140.6	12.3
1983	600.6	808.3	(207.8)	1,381.9	128.8	15.9	160.1	11.6
1984	666.5	851.8	(185.3)	1,576.7	153.8	18.1	175.5	11.1
1985	734.1	946.3	(212.3)	1,827.2	178.9	18.9	209.8	11.5
1986	769.1	989.8	(220.7)	2,132.9	187.1	18.9	253.4	11.9
1987 Est.	824.4	1,015.6	(173.2)	2,372.4	NA	NA	267.3 Actual	11.3

Resources: Statistical Abstract of the United States - 1988; Charts # 470 & 477
Special Analysis: Budget of the United States Government FY 1989

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

On behalf of the National Association of Manufacturers, I would like to thank the Senate Finance Committee for allowing us to submit for the record our views on legislation to repeal Internal Revenue Code Section 2036(c). We commend the committee for holding hearings on this tax issue so critical to small, closely-held businesses.

NAM small business members of the association's Taxation Committee earlier this year listed the "estate freeze" rules of 2036(c) as being one of their most pressing concerns. In this regard, NAM is supportive of legislation that has been introduced in the Senate to repeal the estate tax inclusion related to valuation freezes. S.659 introduced by Sen. Steve Symms, S.838, sponsored by Sen. Howell Heflin and S.849, introduced by Sen. Thomas Daschle would effectively repeal this hastily enacted section. Comparable legislation, H.R. 60, has also been introduced in the House by Rep. Bill Archer.

NAM believes that estate taxes, in and of themselves, have an adverse impact on capital and initiative necessary for industrial activity and expansion of employment opportunities. The association believes that the overall tax burden on estates—at rates of up to 55 percent—should be reduced. Furthermore, the rules of application should be amended to avoid hardships and inequities to estates consisting primarily of equity ownership in closely-held businesses, to prevent forced sale of these firms. For these reasons, NAM strongly supports the aforementioned legislation to repeal 2036(c).

Section 2036(c) was enacted, in an attempt to raise revenue, in the 1987 Omnibus Budget Reconciliation Act. The intent of the provision was to eliminate a perceived evasion of estate taxes, using a practice known as the "estate freeze." Estate planners have long used so-called estate freezes as a means for one generation to pass control of a family-owned business to the next generation. In utilizing an estate freeze, a founder of a company, before his death, would "recapitalize" his firm. This could entail selling or giving his common stock to an heir, while retaining preferred stock for himself. The ownership of preferred stock would enable the founder to retain voting privileges and, thus, some voice in the firm's operation, in addition to receiving dividend income through his retirement years. The common stock, transferred to the younger generation, would reflect the firm's growth and equity increases since the time of the transfer. Essentially, the founder "freezes" the financial value of his interest in the company. At the time of the founder's death, the estate pays taxes on the value of the preferred stock, but not on the increased value of the common stock, now controlled by the new generation of owners.

The estate freeze approach is a fair and honest method of handing down a family firm. Despite the beliefs of some lawmakers, it does not cheat the federal treasury out of revenue. On the contrary, taxes are paid on the value of the transferred property at the time of the transaction. The estate still pays taxes on the value of the decedent's preferred stock. The heirs, generally responsible for the firm's growth and prosperity after the transfer, will pay taxes on the appreciated value of their common stock interests when sold.

In order to block perceived abuses associated with the estate freeze, such as the undervaluation of transferred property, Section 2036(c) basically requires that the total value of property transferred after December 17, 1987, be added back into the decedent's gross estate. This inclusion would be applicable even though the founder may not have been involved in activities that led to the increased value of the common stock and even though the heirs may have paid fair market value for the common stock they own. The 1988 technical corrections law exacerbated this problem by expanding the scope of 2036(c). The safe harbors added to 2036(c), in an attempt to clarify the statute, only serve to suggest that all intra-family transactions not singled out as safe harbors are covered by 2036(c). Among other things, the technical corrections law eliminated language stating that the decedent's retained income or rights from transferred property must constitute a "disproportionately" large share of such income or rights for 2036(c) to be applicable. Significantly, the conferees on technical corrections stated that they recognized "section 2036(c) applies if a parent transfers an existing enterprise or assets from such an enterprise to another enterprise in which a child owns a disproportionately large share of potential appreciation and in which the parent retains an income interest or other rights."

Estate freeze rules enacted in 1987 were not subject to hearings during which tax committee members could have examined less egregious ways to handle instances of abuse or tax evasion. Because of the lack of adequate review granted to this important provision at the time of its passage, it is generally agreed that the end product oversteps the bounds necessary to address the perceived abuses of estate freezes. In doing so, it creates a host of new financial and bureaucratic burdens for family owned and operated firms. The impact 2036(c) will have on small, closely-held family businesses will be devastating for a number of reasons. The most overriding concern is that the punitively high estate tax rates—now applicable to firms that previously attempted to "freeze" their value—may force future generations of family-business owners to liquidate their thriving companies.

Additionally, as currently written, the statute is so broad that it could conceivably be applied to situations other than the typical estate transfers in question. Specifically, 2036(c) could discourage most family business transactions by levying large taxes on estates of individuals who have started a business with their child, loaned money to a corporation in which the child has an interest or who were salaried employees in corporations in which the child has an interest.

Of the more than 13,000 NAM member companies, affiliates and subsidiaries, about 9,000 of the manufacturing firms are classified as small businesses—employing less than 500 individuals. According to a recent survey of NAM's small manufacturers, nearly 86 percent indicated that they are family owned and operated. These firms are well-established and have been operating for many years. More than 60 percent of the respondents indicated that their business had been in existence for more than 26 years—36 percent of the total responding that the business had been in operation for more than 50 years. It follows that a number of these well-established firms will eventually be changing hands, with controlling individuals ready to pass the reins of management and ownership to a new generation. If the estate freeze rules are not amended, current law could cause a large number of these firms to liquidate. Such an occurrence would be disastrous not only for the families involved, but for the individuals they employ, the customers they serve, and the Treasury Department—which would lose a steady stream of revenue in exchange for a one-time estate tax collection.

With the 2036(c) rules in place, the incentive to maintain a profitable small business that may be passed down to children and grandchildren is diminished. As the NAM survey numbers reveal, punitive estate tax provisions could lead to a decline in the growth and proliferation of successful small businesses. NAM does not believe it was Congress' intent in enacting 2036(c) to jeopardize the existence of family-owned firms in an attempt to block isolated abuses of estate tax law.

Reexamining 2036(c) is an admirable first step toward encouraging greater entrepreneurship and subsequent economic expansion created by family-operated businesses. Although we recognize serious fiscal restraints face our nation today, NAM holds that an even more desirable step would be eventual elimination of federal estate taxes on transfers of interest in, or assets of, a closely-held business from one family member to the next. Such a move would help ensure the continued prosperity of small family run business operations that are responsible for critical federal revenues as well as employment, economic growth and expansion.

STATEMENT OF THE SMALL BUSINESS COUNCIL OF AMERICA, INC.

(SUBMITTED BY HAROLD I. APOLINSKY)

Mr. Chairman and Members of the Committee, my name is Harold I. Apolinsky. I am the managing member of Sirote & Permutt, P.C., an Alabama law firm. My primary area of practice is Estate Planning. I teach Estate Planning and have done so for over 15 years at both the University of Alabama School of Law and the Cumberland School of Law. I am currently active in, and have held leadership positions in, the American Bar Association Section of Taxation, The Alabama Bar Association Tax Section, the American College of Tax Counsel and the Estate Planning Council of Birmingham.

Today, I am privileged to express my views both personally and as Vice President of the Small Business Council of America, Inc., commonly referred to as SBCA. SBCA is a nonprofit, nonpartisan national organization of approximately 1,000 small businesses, which provides a tax voice for the 17 million often overlooked small businesses in our country. With its leadership of tax experts, SBCA's primary goals are to prevent federal tax laws from becoming more burdensome on small businesses and their owners and to support legislation which creates needed economic incentives.

The SBCA joins many other prominent, concerned organizations in supporting Senate Bills 659, 838, and 849, the bills you are considering, calling for a repeal of Section 2036(c) of the Internal Revenue Code.

Section 2036(c) has not received much publicity as yet. Its scope and impact are virtually unknown by the people who will be most seriously affected by it. They have not died. The so-called "estate freeze" rules, enacted in 1987 and revised last year by TAMRA, have created unwarranted adverse affects on family-owned businesses and farms. This provision should be known as the "anti-family business" Code section.

Section 2036(c) was enacted, without any hearings in the Senate or the House of Representatives, to stop family business owners from exchanging common stock which grows in value if the business becomes more valuable, for preferred stock which is frozen in value. This approach may have been first used by the Dupont family around 1935. It has been used by many family business owners for over 50 years.

Is it an abuse to be stamped out to give or sell common stock of a family business to working children while parents desiring to work less retain voting or non-voting preferred stock? Is it an abuse for parents owning farms to give or sell to children partnership interests which grow in value while retaining interests which are frozen?

Is it not more consistent with our system of free enterprise and entrepreneurial spirit to encourage family owned businesses to grow, be productive and stay within the family? Or should the goal be to force the most successful to be sold or liquidated?

To save the business or farm for the children, parents are giving up the growth in a very real sense. Consider the example of parents who own 100% of a farm presently worth $1,000,000. Before 2036(c) they could, at the time they wanted to reduce their work commitment, create a family partnership and exchange their ownership for an $800,000 frozen partnership interest and give or sell non-frozen interests worth $200,000 to their children who wanted more participation. If the farm were unexpectedly sold ten years later, instead of being left to the children, for $2,000,000, the parents would receive $800,000 and the children $1,200,000. Income taxes would be paid by all. Growth was shifted ten years earlier in a very true sense. This result is most appropriate since the efforts of the children enhanced the value of the farm.

Section 2036(c) would discourage many other normal intra-family transactions involving family businesses, family farms and family investment arrangements. In addition to the preferred stock or frozen partnership example discussed before, a significant tax could occur in any of the following situations if an individual

1. Gives or sells, even for fair market value, an interest in a corporation or partnership to his or her child;
2. Loans money (even at a market interest rate) to a corporation in which the child has an interest;
3. Is a salaried employee of a corporation in which a child has an interest;
4. Enters into a buy/sell arrangement with a corporation or partnership containing a formula purchase price (which is traditionally done and respected) if the individual's child is also a shareholder or partner, even though the same agreement would not give rise to any such tax if all the shareholders or partners were non-family members;
5. Hires a child to work in the family business if that business contains an ESOP (employee stock ownership plan); or
6. Starts a new business with his or her child.

The taxes could be as high as 55% or 60% of the appreciation in the value of the business from the date of the event described above to the individual's death. The child could be required to pay this tax at the death of the parent even though the child may have originally purchased the interest in the business from the parent for fair market value, and was solely responsible for the success and appreciation during those years.

Practitioners can only speculate as to under what circumstances the statute will apply. Thus, small business owners are effectively paralyzed because they are unable to determine the consequences of their actions under the law as it now exists. Small business owners deserve to know, or at least be able to determine, the consequences to everyday business transactions.

The family business or farm is typically the main asset, life blood and security for the family. It should not be subjected to an unknown set of "make it up as we go along" rules by the Internal Revenue Service. Bringing children into the family activity should be encouraged and promoted—not made difficult, costly, and, from a practical perspective, often impossible—which is the result of the new 2036(c).

We hope that this Committee will adopt legislation to repeal retroactively Section 2036(c).

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

(SUBMITTED BY DAVID R. BURTON [1])

The U.S. Chamber of Commerce supports the repeal of Section 2036(c) of the Internal Revenue Code—the so-called estate freeze rules. This complex and confusing law was enacted in 1987 without Congressional hearings or debate. Many families who will be affected by the law are just now discovering its existence. It calls into question the viability of many commonly used methods of transferring business assets from one generation to the next and thereby jeopardizes the continuity of family ownership of many farms, ranches, and businesses.

Several bills have been introduced to repeal Section 2036(c). Senator Daschle has introduced S. 849, Senator Symms has introduced S. 659, and Senator Heflin has introduced S. 838. Representative Bill Archer has introduced H.R. 60 which has more than seventy cosponsors. The repeal of 2036(c) is preferable to further attempts to amend the law. Such attempts will only increase the law's complexity and are unlikely significantly to help family businesses.

The repeal of Section 2036(c) would not result in a significant loss of revenue. When the law was enacted in 1987, it was estimated that it would raise only $109 million over three years. This amount of money does not justify the law's potential harm to family enterprise and does not support the argument that there was substantial tax avoidance in previous intrafamily transfers.

The Chamber is working for the repeal of Section 2036(c). It has produced an *It's Your Business* television program examining the law and its potential impact and has published several articles and position papers supporting the law's repeal. The Chamber will continue to take every opportunity to voice its opposition to this law and work for its repeal.

Defenders of Section 2036(c) argue that the law is necessary to curb tax avoidance schemes devised by clever estate planners. Yet the law eliminates some of the most commonly used and heretofore legitimate methods of passing a family business from one generation to the next without incurring an estate tax liability so large that it forces the sale of the business outside of the family. Those who will suffer from the law are hard-working families who hope to pass their businesses intact to future generations.

Family-owned enterprises are the essence of the American dream; the family farm and family business are the backbone of the American economy. The family farm has made America second to none in agricultural production and productivity. The spirit of hard work and entrepreneurship necessary for success in family business results in the creation and marketing of ideas and inventions that large, established corporations would shun.

Building a family business offers many rewards. Perhaps the greatest is the knowledge that a business that is the result of a lifetime of hard work can be passed on to one's children and grandchildren. Unfortunately, passing on a family business intact can be a difficult task. The first $600,000 of an estate is exempt from tax. However, many small businesses and farms are worth far more than this. The federal estate tax begins at 37 percent of amounts above $600,000 and increases to 55 percent of assets above $3 million. In short, a good deal of cash can be required to pay estate taxes. If an estate does not have sufficient cash to pay the taxes or if the heirs cannot afford to buy the business, the business may have to be sold outside of the family to pay the taxes.

One of the more common methods of ensuring that a business would not have to be sold to pay estate taxes was the use of the estate or valuation "freeze." The estate freeze typically involved an aging founder recapitalizing the business. Much of the current value and voting power and/or income is allocated to preferred stock, which is retained by the founder. The founder then gives or sells common stock to his heirs. The future increase in value of the business is allocated to the common stock and would generally not revert to the founder's estate upon his death. The founder's preferred stock will not rise in value, and at death estate taxes will be owed on only the value of that preferred stock. Had the estate freeze not been used, estate taxes would have been owed on the entire value of the business.

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The estate freeze is not unfair to the federal Treasury. When the firm is recapitalized, the founder is typically old, and it is the heirs that remain active in the business and make it more valuable. It is, therefore, appropriate that taxes on that increased value should be paid by the heirs when they either sell the business or die.

The estate freeze and similar intrafamily transfers are no longer a viable means of passing a family business from one generation to the next. Section 2036(c) states that any person holding a "substantial interest" (defined as 10% of the voting power or income stream) in an "enterprise" who "in effect" transfers after December 17, 1987, property having a "disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining an interest in the income of, or rights in, the enterprise," shall be deemed to have retained the enjoyment of the transferred property. This means, quite simply, that any increase in value attributable to the assets transferred to the heirs through the typical estate freeze will revert to the transferor's estate upon death. This can mean the end of a business or farm with a significant amount of nonliquid assets. Al the American College of Probate Counsel has pointed out, Section 2036(c) "unfairly favors families whose wealth is represented by cash and marketable securities over those who own farms or small businesses."

Elimination of the estate freeze is a severe enough blow to a family business. Yet Section 2036(c) can affect more than the generic estate freeze. This law calls into question the viability of-a number of methods of making intrafamily asset transfers; it may adversely affect transfers pursuant to family buy-sell agreements and similar intrafamily transfers. Anyone who owns as little as 10% of the voting power or income stream from a business will be affected.

The complexity and potentially far-reaching effects of Section 2036(c) are indicative of a disturbing trend. Family businesses are increasingly required to comply with confusing regulations and pay burdensome taxes. In this case, only years of litigation will determine which intrafamily transfers are covered by Section 2036(c) and which are not. Tax attorneys and business planners are confused by the law. Consequently, family businesses are receiving conflicting advice.

Section 2036(c) places an unwarranted burden on family business and should be repealed. Tax laws should help to preserve family businesses and farm—of encourage their sale and breakup.

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